S. HRG. 109–1065

FHA: ISSUES FOR THE FUTURE

HEARING

BEFORE THE

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

PROPOSED CHANGES TO MODERNIZE FHA, ENABLING THE AGENCY TO MEET CHALLENGES WITHIN THE MORTGAGE-LENDING INDUSTRY AND TO CONTINUE EFFECTIVELY SERVING LOW- AND MODERATE-INCOME HOME BUYERS

JUNE 20, 2006

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

49–425 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND TRANSPORTATION,
Washington, DC.

The Subcommittee met at 2:32 p.m., in room 538, Dirksen Senate Office Building, Senator Wayne Allard, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Today the Subcommittee on Housing and Transportation will hold a hearing to examine the Federal Housing Administration, FHA. FHA has been an important source of home ownership for millions of Americans since its inception in 1943. It has been especially helpful in allowing low-income and first-time home buyers to achieve the American dream of home ownership.

As we all know, though the financial markets have changed a great deal since 1934, in fact, the housing finance markets have changed a great deal in just the last decade and FHA's market share has declined. This leads to what I believe is one of the central questions of today's hearing: what is the role of FHA today and into the future?

The answer to this question undoubtedly shapes the kind of reforms that Congress should be considering.

I believe that the success of FHA and HUD is not determined solely by market share. After all, we have seen record-high levels of home ownership simultaneously with the declining FHA market share. Just because homeowners are not being served by FHA does not mean that they are not being served.

So we return to the core question of what should be the role for FHA?

A number of different people have attempted to answer that question through various reform proposals. FHA has offered its own proposal that would significantly reshape the Agency's mission. First, FHA has asked to institute risk-based pricing along with the ability to increase its maximum premiums.

Second, the FHA proposal would raise loan limits both across the board and in high-cost areas.

Third, HUD proposes a new zero down mortgage product. The package would also eliminate audit and net worth requirements for mortgage brokers, eliminate the current cap on reverse mortgages, authorize a 40-year mortgage product, restructure the manufac-

turing housing programs and streamline the condominium program.

Many of these reforms are significant and merit close attention from Congress. Because FHA has been such an important program in promoting home ownership, changes of this magnitude should not be taken lightly. It is crucial that we make careful, responsible changes to ensure that FHA is available to home buyers for years to come.

Today's hearing will give the Subcommittee an opportunity to better understand the changes being proposed, as well as the implications for FHA home buyers and the taxpayers.

Before discussing reform, though, I believe that we must take a step backward. First and foremost, FHA must get its existing house in order, since it continues to be considered high risk by the GAO. It would be irresponsible to expand a seriously troubled program.

I want to commend Commissioner Montgomery for his efforts on this point. He has undertaken a number of initiatives designed to improve the existing FHA programs, making them more efficient and less susceptible to waste, fraud, and abuse.

We must also carefully consider the appropriate role for FHA relative to the private markets. Historically, the role of FHA has been to complement, not compete with, the private markets. FHA's proposal would begin to shift this role, while also moving FHA away from its traditional mission to serve low-income and first-time home buyers. Such a change must be carefully considered.

I want to be absolutely clear that I do not oppose the FHA reform. I simply want to be certain that the reform is done right. While I believe that FHA is in need of reform, we must first ensure that FHA is on solid financial footing and has the capacity to implement and manage any changes.

Our witnesses today will be helpful to the Subcommittee as we attempt to answer these questions. On the first panel I would like to welcome FHA Commissioner Brian Montgomery. During the time he has been at HUD, Commissioner Montgomery has moved vigorously to modernize and improve FHA.

I would also like to welcome Mr. William Shear of the Government Accountability Office. GAO has completed a series of reports on FHA and Mr. Shear will provide key guidance as to HUD's capacity to implement various reforms.

We also have a number of very distinguished witnesses on the second panel: Ms. Regina Lowrie, Chair of the Mortgage Bankers Association, will provide her group's recommendations for reform. As we all know, this is an issue that the Mortgage Bankers Association has been working on for some quite some time.

Mr. Tom Stevens, president of the National Association of Realtors, will outline the Realtors priority within FHA.

Mr. A.W. Pickel, president of LeaderOne Financial will testify on behalf of the National Association of Mortgage Brokers.

Mr. Ira Goldstein of The Reinvestment Fund will share the perspective of an affordable housing developer.

And finally, Mr. Basil Petrou, of Federal Financial Analytics, which share findings from his research.

I would like to welcome all of you and thank you for taking the time to be here today. You are all leaders and experts within your field and your testimony will be helpful as the Subcommittee continues to consider this issue.

Ranking member Reed and I have had the good fortune to work together on FHA issues in the past, such as downpayment simplification and increasing multifamily loan limits. I look forward to working closely with him as we find ways to define a modern FHA for the future.

Senator Santorum, who has a couple people here from Pennsylvania, wanted to make sure that I got his statement in the record. He is unable to make it. I would ask that Senator Santorum's statement be put in the record behind Senator Reed, and also ask unanimous consent that Senator Reed's statement will be included behind my statement.

I think we will start with you, Mr. Secretary, and then we will go to Mr. Shear. Proceed.

STATEMENT OF BRIAN D. MONTGOMERY, ASSISTANT SECRETARY FOR HOUSING AND FEDERAL HOUSING COMMISSIONER, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. MONTGOMERY. Thank you very much, Chairman Allard and ranking member Reed, for inviting me to testify on the Administration's proposed FHA Modernization Act.

I also want to thank Senator Talent and Senator Martinez for their introduction yesterday of S. 3535, the Expanding American Home Ownership Act of 2006, as well as Senators Chambliss and Isakson for their support.

I would like to begin the session by reminding everyone why FHA put forward this legislative proposal. It would have been very easy for us to sit back and continue to do what we have been doing for years and that would be the status quo. But we heard the concerns voiced by public policymakers, including members of this esteemed body, that many home buyers were putting themselves in harm's way. Hundreds of thousands of families, many of them low-income, were choosing, or worse being steered toward, risky high-cost loans. In good conscience, Mr. Chairman, we had to act.

Senator Reed said at my confirmation hearing that FHA needed to raise the loan limits to better assist his constituents. We listened to Senator Reed and his idea is a part of this proposal. The bottom line is we decided that FHA should play the role it was intended to play. It just needed a long overdue modernization effort to do so. Because of limited time, I thought it would be beneficial for me to directly address three main reasons why this proposal is so important. I will start with reason number one. This proposal is good for American home buyers, for families that have worked hard to save for home ownership and who need a safe affordable financing option.

Let me be very clear. Although FHA serves riskier borrowers, we serve families who are capable of becoming homeowners. Our underwriting standards are designed to determine which borrowers represent an appropriate level of risk and which of those do not. And that, Mr. Chairman, will not change.

With a risk-based premium structure, FHA could reach more borrowers, borrowers who simply do not qualify for prime financing today. And FHA can do it at a substantially lower price than these borrowers would pay for a subprime loan.

For example, each 1-percent increase in the upfront mortgage premium on a $200,000 home costs approximately $12 a month. For this low monthly payment, a borrower can get a market rate loan.

Compare this $12, roughly the price of a pizza, to the additional cost of a loan with the interest rate priced for risk. On average, subprime borrowers pay an interest rate three points higher than conventional borrowers. That rate hike translates into an additional $255 a month, and that is $125,000 over the term of the loan.

Reason number two, this proposal is good for FHA, improving the financial soundness of the fund and our ability to manage risk. While we are in a sound financial position today, this proposal brings FHA in line with the rest of the industry, where risk-based pricing is standard practice, and certainly in line with the way other insurance companies operate.

Again, let us be clear about FHA's financial solvency. Our Mutual Mortgage Insurance Fund has never, I repeat never, operated in the red. As required by Congress, we annually reestimate the financial position of the total FHA portfolio. Sometimes the estimates indicate that we will do better than previously predicted. Sometimes they show that we will do worse. This is what happens when you are in the business of managing and predicting risk.

In either case, there is no cost to the taxpayer. We either increase the estimated amount in FHA's capital reserve, which is now $22.6 billion, or we reduce that amount. Since 1990, we have generated more than $29 billion in potential income, which has been offset by $18.8 billion in reestimates of potential losses. That means that FHA's projected average annual net income over the past 16 years has been $670 million per year.

Contrary to what some believe, FHA is not, nor has it ever been, losing money.

Finally, the MMI Fund is not intended to provide a return on investment like a business. That is, FHA's main purpose is to serve a social need, not to make money.

Reason number three—my final point—this proposal is good for the private sector, as it expands the borrower pool and provides the real estate financing industry with the appropriate products to reach higher-risk home buyers.

Remember, FHA is not a lender. Our role is to provide home buyers access to market-rate financing by insuring lenders against loss. We are seeking to serve borrowers who do not qualify for prime loans but who do meet FHA's own eligibility criteria.

Also, FHA will not encroach on the government-sponsored entities (GSEs), which have their own critical role to play, supporting prime conventional financing. A recent study showed there is very little overlap between GSEs and FHA, somewhere between 10 percent and 14 percent. In fact, approximately 90 percent of FHA borrowers cannot even qualify for a prime conventional loan.

Finally, a viable FHA will not take business from the private mortgage insurers. Private mortgage insurers (PMIs) serve a different client, namely less risky borrowers. Due to their profit-motivated business structure, PMIs simply cannot reach FHA-type borrowers at the same low price that we can.

The PMIs did not serve the high-risk lower-income borrowers yesterday, they do not do so today, and they certainly will not tomorrow, even with the passage of S. 3535 because there is no money in it for them.

If the PMIs are afraid that our proposal will hurt their business, then their fears are unfounded.

Further, unlike the PMIs, FHA can and does stay in all markets all the time. Perhaps the best example of this difference can be seen in the oil-pad states during the 1980s. Data shows that the PMIs pulled out of several states while FHA business actually increased because they stuck it through. That is probably no more telling than in the State of Texas between 1984 and 1987, when PMIs business dropped from 44 percent to less than 10 percent of the market.

In summary, FHA has a very specific and very critical role to play. This legislative proposal is not intended to expand the reach of the Agency beyond what is appropriate and necessary in today's market. We are simply trying to serve those lower-income families who need the benefit of a Government insurance product to achieve home ownership at a fair price.

Thank you for this opportunity to testify and I look forward to your questions.

Senator ALLARD. Thank you for your testimony.

We have had a couple of members show up, so I would like to now call on Senator Reed.

I would like to inform the members that we have a vote that is scheduled now and we may have to break to go ahead. There are two votes so it might take us some time. So I am going to try and run this up to the last few minutes of this vote. Then we can go and catch the tail end of this vote and then catch the first on the other vote.

Hopefully, we will keep our period of time where we disrupt the hearing to a minimum.

Senator REED.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman. And thank you, gentleman, for your testimony today.

It is not an overstatement to say that the FHA has played a critical role in the development of the U.S. housing market since its introduction during the Great Depression. Backed by the guarantee of FHA mortgage insurance, mortgage lenders were able to provide terms that made home ownership a possibility for a much larger share of America's families. Today's high ownership rates are a result of FHA activities over many, many years.

Recently, FHA also pioneered the home-equity reverse mortgage, which has given seniors a new opportunity to realize the value of their homes.

Despite earlier policies that made it difficult for many households to obtain FHA-insured loans, FHA has, for many decades, been recognized for its critical role in helping minority and low-income families become homeowners.

Today we are here to begin a conversation about FHA's future. This conversation takes place in the context of a lending industry that is changing rapidly. Three developments are of particular note. First is the growth in the number of institutions and programs that serve low-income and first-time buyers.

Second is the much broader use of mortgage products other than the additional 30-year fixed-rate loan, such as the ARM and the interest-only mortgage.

And finally, the third is the growth of the subprime sector of the lending market.

Over this same period of time, FHA's share of the lending market has fallen sharply from about 12 percent in the late 1990s to about 3 percent today. This is not due simply to the growth in the private lending sector but also reflects a loss of borrowers who traditionally would have gotten FHA loans, particularly a loss to the subprime market. This is a source for concern.

There are real reasons to believe that many of the new mortgage products decrease the likelihood that a family will be able to maintain home ownership over the long run. The cost of the subprime loan to the borrower is often unnecessarily high for the amount of risk entailed. The rate of foreclosure in the subprime sector is higher than in other parts of the lending sector. And predatory lenders, while only a very small part of the subprime market, destroy the dreams of home ownership and wealth accumulation for some of America's most vulnerable households.

In proposing major changes to the FHA, HUD has stressed the goal of providing borrowers at the lower end of the market with better and safer alternatives. We have to look carefully because we do have to do more, I think, to serve these low-income and minority borrowers.

We must also address serious issues about performance and perception with respect to FHA. FHA's foreclosure rate is well below that of the subprime market but is well above that of the private sector and the gap between the FHA and the prime sector has increased considerably in the last 5 years.

While FHA still provides a net subsidy to the Treasury, the size of that subsidy has fallen markedly because of an increase in defaults.

FHA procedural requirements are considered by many in the lending industry to be unduly cumbersome to meet. And in some cities a geographic concentration of FHA loans that have gone to foreclosure has raised the perception that FHA contributes to urban blight.

But despite these problems, as history clearly shows, FHA's status as a public agency provides it not only with a special duty but also with a special ability to push the envelope so that American households have better housing choices.

Today we are beginning a discussion that will consider not only the role FHA can and must play, but also the tools that it would need to carry this role forward.

I look forward to the witnesses and, again, thank you, Mr. Chairman, for holding this hearing and your opportunity today.

Senator ALLARD. Thank you for your statement.

Senator Martinez, do you have a statement? girl are you kidding

STATEMENT OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Mr. Chairman, thank you very much. I want to thank you and Senator Reed for holding this hearing.

Senator ALLARD. Former Secretary of HUD, I might add.

Senator MARTINEZ. Yes, sir, and I welcome my former colleagues. It is always good to see friends.

But I believe it is a very important and timely topic. Over the past 72 years, FHA has been an industry leader, helping more than 34 million Americans become homeowners at no cost to the taxpayers.

In recent years, while the mortgage industry has adapted to changes in the marketplace, FHA has stayed the same, leaving many home buyers with no option but high-cost, high-risk mortgages. FHA has lost valuable market share over the recent years, falling from around 12 percent in the 1990s to approximately 3 percent today.

In light of these developments, I appreciate the opportunity to be here this afternoon to examine current issues affecting FHA and to discuss the ideas for improving the Agency's role in providing home ownership.

Yesterday, Senators Talent, Chambliss, Isakson, and I introduced reform legislation that would give FHA the needed flexibility to support sound lending in the 21st century. This bill incorporates a number of reforms aimed to increase market share, including risk-based premiums, eliminating downpayment requirements, increasing loan limits and terms, and removing the cap on reverse mortgages. This legislation is critical to the residents of my State.

In fiscal year 2002, more than 58,000 Floridians used FHA to purchase their homes. In fiscal year 2005 that number plummeted to just under 18,000. The bill's loan limit increase alone could almost double the number to more than 32,000, resulting in a savings of $64 million to Florida homeowners who are now paying subprime prices.

FHA is essential in order to protect consumers and encourage low-income and minority home ownership. I look forward to this hearing and the testimony from our witnesses and working with the Subcommittee on this important issue as we attempt to move it forward.

Thank you, Mr. Chairman.

Senator ALLARD. Thank you, Senator Martinez.

We will now proceed with our second witness, Director Shear from the GAO. We are looking forward to your testimony.

STATEMENT OF WILLIAM B. SHEAR, DIRECTOR OF THE FINANCIAL MARKETS AND COMMUNITY INVESTMENT TEAM, GOVERNMENT ACCOUNTABILITY OFFICE

Mr. SHEAR. Thank you very much.

Mr. Chairman, Senator Reed, members of the Committee, it is a pleasure to be here this afternoon to discuss four of our recent reports on the Federal Housing Administration.

My testimony focuses on FHA's actions to better evaluate and manage risk associated with its mortgage insurance operations.

Today I will discuss: First, FHA's development and use of its mortgage scorecard, an automated underwriting tool that evaluates the default risk of borrowers.

Second, FHA's annual estimation of program costs.

Third, practices of other mortgage institutions for managing risk of new mortgage products that could be instructive to FHA.

And fourth, FHA's management of risk related to loans with downpayment assistance.

Our findings are particularly important as this Committee considers HUD's proposed legislative changes, especially those that would give the agency flexibility to set insurance premiums based on the credit risk of borrowers and to reduce downpayment requirements from the current 3 percent to potentially zero.

To implement this legislative proposal, FHA would have to manage new risks and accurately estimate the costs of program changes. For example, to set risk-based insurance premiums, FHA would need to understand the relationships between borrower and loan characteristics and the likelihood of default, as well as how the premiums would affect the fund's financial condition.

In summary, our past work identified a number of weaknesses in FHA's ability to manage risk and estimate program costs. First, while generally reasonable, the way that FHA developed and uses its mortgage scorecard limits the scorecard's effectiveness. FHA and its contractor used variables that reflected borrower and loan characteristics to create the scorecard, as well as an accepted modeling process to test the variables' accuracy in predicting mortgage default.

However, the data used to develop the scorecard were 12 years old by the time that FHA began using the scorecard in 2004 and the mortgage market has changed significantly since then.

Second, FHA's subsidy reestimates reflect a consistent underestimation of the cost of its single-family insurance program. For example, as of the end of fiscal year 2003, FHA submitted a $7 billion reestimate for the fund. Increases in the expected level of insurance claims was the major cause of the $7 billion reestimate.

Third, some of the practices of other mortgage institutions offer a framework that could help FHA manage the risk associated with new products, such as no downpayment mortgages. For example, mortgage institutions may limit the volume of new products issued—that is, pilot a product—and sometimes require stricter underwriting on these products. FHA officials have questioned the circumstances under which pilot programs were needed and also said that they lack sufficient resources to appropriately manage a pilot.

Fourth, FHA has not developed sufficient standards and controls to manage risk associated with the growing proportion of loans with downpayment assistance.

We found that loans with downpayment assistance, especially from seller-funded sources, performed substantially worse than comparable loans without such assistance.

In the four reports, we made several recommendations designed to improve FHA's risk management and cost estimates. FHA has taken actions in response to some of our recommendations. While FHA's actions represent improvements in its risk management, additional improvements will be important if FHA is to successfully implement some of the program changes HUD has proposed. Accordingly, consideration of this proposal should include serious deliberation of the associated risks and the capacity of FHA to mitigate them.

Again, it is a pleasure to be here. I would be happy to answer any questions.

Senator ALLARD. This is for you, Secretary Montgomery. HUD's proposal, particularly the zero down and the risk-based premiums, will require a strong ability to assess and manage risk. Yet a number of entities have questioned HUD's ability to do just that. And I would like to quote some of these agencies and then get a response from you in that regard.

From GAO, they say this: "The way that FHA developed and uses its mortgage scorecard, while generally reasonable, limits how effectively it assesses the default risk of borrowers."

From the Inspector General, they say "FHA must incorporate better risk factors and monitoring tools into its single-family insured mortgage program risk analysis and liability estimation process."

And then it goes on to say that "FHA cannot determine current risk trends in its active insured portfolio."

From the Congressional Budget Office, they say that "risk-based pricing is complicated, requiring much precision in the underwriting process."

In the President's fiscal year 2007 budget, they say "the program's credit model does not accurately predict losses to the insurance fund."

And yet, in your testimony you state that "the FHA bill proposes to strengthen FHA's financial position, improving FHA's ability to mitigate and compensate for risk."

You go on to say, in your statement, that "I want to reassure you that the changes we are proposing will not increase the overall risk of the MMI Fund."

Given the questions that have been raised regarding FHA's ability to assess risk, share with me how you feel that the proposal that you have suggested will not increase risk. And then what has FHA done to improve its ability to assess and manage risk in recent history?

Mr. MONTGOMERY. Thank you very much, Senator.

On the first point, we firmly believe that actually pricing it to the risk, which is largely what the insurance industry does in this country, would actually help us better manage the fund by spreading it and pricing it commensurate with the risk. We can identify

borrowers who would be less risky and identify those who would be more risky.

Today we have a one-size-fits-all that is not fitting all. A lot of borrowers who might be better suited toward FHA have been steered toward other loans. Again, that is something we are trying to change.

I will say this relative to the reestimate, I think it gets to the key of your question, is the $7 billion reestimate was done as the result of an error that HUD discovered. And that is at the time no one knew how risky these gift downpayment programs would be. That has actually been the largest reestimate to the MMI Fund in recent memory, again some $7 billion.

I actually use that as a point to point toward how HUD can manage the risk, that working with a contractor—we now have a new contractor, by the way, we got rid of the other one. That allowed us then to—again, we are constantly readjusting the risk. We have $29 billion in potential revenue out over the last 16 years. We have reestimated about $18 billion, which still leaves us $670 million a year in projected net income, despite the fact, sir, again that we have the more risky borrowers today and the fact that we had to do a $7 billion reestimate because nobody knew how popular and how more risky that these gift downpayment programs would be.

So despite all of that, and also considering the fact that the gift downpayment programs are largely going away because of a revenue ruling by the IRS, I think that leaves us on excellent footing today, financial footing, to proceed forward with a risk-based premium structure.

Senator ALLARD. I have seen some studies that indicated that the more that is paid down in the downpayment phase of the loan, the less your loan failures are. Have you seen those figures?

Mr. MONTGOMERY. It is no secret that higher LTV loans tend to have higher foreclosure rates. But I would also say, given the popularity of these gift downpayment programs, it just cries for the fact that some lower-income borrowers need some sort of assistance.

Now sir, again, by pricing the risk accordingly, we can look at the family's individual portfolio, whether it is FICO scores, debt-to-income, any number of variables that now say that you may be a good candidate for a zero downpayment program.

Or it can be a half percent. Or it could be that a family may have to pay even more than that. Again, sir, it now allows us to look at each family's individual portfolio. And even more importantly, allow us to reach deeper into the borrower pool.

Senator ALLARD. Mr. Shear of GAO, do you believe that FHA currently has the risk assessment capacity to implement the proposed changes in a safe and sound manner?

Mr. SHEAR. In the four reports I have discussed, we have raised the concerns noted in my statement with FHA's current ability to assess and manage risk and its historical record in doing so.

We are pleased to see that they are implementing some of our recommendations. But, for example, when you look at FHA's TOTAL scorecard, we see an updating that might occur by the year 2007, but we are still looking for basically how that is going to be achieved.

There are still a lot of open questions to us, in terms of where FHA is and what progress it will make. We call for continuous improvement. We think FHA is improving in the ability to assess and manage risk, but we think that FHA has a way to go. And for this proposal, it probably becomes more important for FHA to expand this capacity.

Senator ALLARD. Let me recognize Senator Reed.

Senator REED. Thank you very much, Mr. Chairman. And thank you, gentlemen.

Secretary Montgomery, the FHA qualifies the lenders and brokers that participate in the program. And I understand there are some that propose to lower the standard for brokers. Do you have any concerns about the standards with respect to brokers? And what is the status of the proposals in that regard?

Mr. MONTGOMERY. We are required by Congress to operate FHA in a financially sound manner. And for many years that gauge has been an audited financial statements if you are an independent broker.

We also realize sir, on the other hand, and also hearing from SBA's Office of Advocacy, that a lot of brokers are small mom-and-pop, if you will, organizations. And many of those have expressed concerns that it is an expensive requirement for a small business.

So we are trying to, on the one hand, make sure that we are offering the fund and with lenders, because it is the full faith and credit of the U.S. Government, to make sure that we are not left holding the bag, so to speak. But by the same token sort of recognizing that we are making it more difficult for small businesses to operate, especially considering the fact that brokers originate anywhere from 62 to 66 percent of loans today.

I will say, sir, that we are still in consultation with them. They have been floating a proposal for a surety bond. On the one hand, that could be a good proposal in each individual State. But on the other hand, we need to make sure that the MMI Fund is protected.

So we continue to meet with them. We continue to discuss with them ways that we can make it less onerous for some of their colleagues.

Senator REED. Do you maintain statistics on broker performance and lender performance, particularly with respect to defaults?

Mr. MONTGOMERY. Yes, sir, I believe we do but I do not have those with me

Senator REED. That would be something that you would also consider, in terms—

Mr. MONTGOMERY. We do that with every FHA-approved lender, whether it is a broker or a warehouse line or a large lender such as Countrywide or Wells Fargo. We maintain those statistics across the board.

Senator REED. A presentation given to the Committee staff by HUD suggested that many borrowers who could qualify for better terms are being steered to the nonprime mortgage market. We are proposing to give you enhanced power.

But even today, if FHA terms are better, but still intermediaries are steering people away to the subprime market, what can we do? How can we work to avoid this adverse selection process where they are sent off to the subprime market?

Mr. MONTGOMERY. Sir, we are doing all we can on that front. I will say from the first day I took office, and we use the term market share because it is better descriptive, but we realize we are not a corporation. As we pored over the home mortgage disclosure data, it became very obvious to us that a lot of families, particularly lower-income families, were steered toward subprime products. You can only look at the explosion in that industry over the last 10 years to see that.

Now if you want to believe a settlement involving a large subprime lender and 49 States Attorney Generals, the term steered is very appropriate in that case and a lot of families were taken advantage of.

Now if a lot of those families had gone to a prime conventional product, I probably would not be sitting in front of you today. We want what is in the best interest of the family, particularly low-income families.

But it did not sit well with us, sir, the fact that these families had been taken advantage of, especially the fact that some of them were lower down the income strata, or lower credit scores because of our requirements under the capital reserve and the MMI Fund that we could not reach them with our present structure.

So I want everybody to fully understand, sir, and I am glad you brought up this point, that is the key reason we began this endeavor, was a way that we could reach those families either through a better marketing and public awareness campaign, but also improving FHA processes—which we have been doing—but more importantly, sir, improve the products to where we can provide low-income borrowers a better product at a much fairer price.

Senator REED. Thank you very much, Mr. Secretary.

Let me direct a question to Mr. Shear. What do you believe the impact will be on the overall market, the lending industry, including entities such as GSEs, if the FHA changes are put in place, as suggested by Mr. Montgomery and others?

Mr. SHEAR. We have not evaluated the interactions between FHA and the conventional market for close to a decade now, except for the one report I discussed where we looked at the expansion in low and no downpayment products offered by the conventional sector.

So, I cannot directly answer your question but can say there are certain questions that we would want to look at that bear on this issue.

In terms of FHA's decline in market share, the question is what are the causes of that decline in market share—that is, trying to get behind it in a more complete way, trying to become more current. Commissioner Montgomery just referred to a study about the overlap between FHA and the GSEs, which was based on data that went through the late 1990s. One could envision getting updates on that type of information.

So these are the types of questions we would be looking to have answered to address the overall issue. Unfortunately, we have not done the work to address those questions.

Senator REED. Are you proposing to do the work, Director Shear?

Mr. SHEAR. We do what is called upon by Congress. I would just say that—I would say that we would welcome it if we were called upon to do it.

Senator REED. Thank you.

Senator ALLARD. Senator Martinez, we have got 15 minutes and the vote is running to an end here.

Senator MARTINEZ. I will go very quickly with just a couple of questions.

Secretary Montgomery, I just wanted to ask you, to be sure I understand the purpose of your goal, which we have believed in enough to file us a bill.

My understanding is that many, many people at the lower spectrum of home buying, in other words entry level into the market, are finding it necessary either to forgo home purchases or are financing it through what would be not predatory lending, but it would be high-cost lenders at an end of the market that does it for folks who do not have a good credit history, as a new home buyer often might now, or may not be able to put a downpayment on a home that is significant, and things of that nature.

And what you are seeking to do, as I understand it, is to broaden your ability to serve that marketplace, to serve those people with a product that would be less costly, and would give them an opportunity to get into a home, where now they are either falling prey to very high-priced lending, or otherwise are just not in the market because they cannot get into the private market.

Mr. MONTGOMERY. That is absolutely correct, Senator.

Senator MARTINEZ. That is called a softball, by the way.

Mr. MONTGOMERY. Football was more my game.

That is exactly right, Senator. And a lot of those were our traditional borrowers. And you are going to hear from a second panel here later, but in particular the Realtors and lenders, the mortgage brokers will tell you, I am talking about the process side of FHA which contributed to the percentage of people using FHA plummeting, is that they did not like doing business with us. Our IT system was antiquated. We required thick case binders of loan documents to go from our home ownership centers to lenders. If an I was not dotted and a T was not crossed, back they went. That cost time.

If I was a Realtor or a broker or a lender, and I do not get paid until the loan closes, if FHA is stuck in the late 1970s, then of course I am not going to do business with them.

So before we even began to look at the product side, we knew we had to improve the process. And we have done a lot of changes over the last year to do that.

I think, as evidenced by the support from the Realtors and others, they would say that we have made it less onerous to do business with FHA. Since we do not have the sales force, sir, we are not a retail operation, we require lenders and Realtors to, in effect, say if you are a borrower that might fit into FHA, to make them aware of it. I think we have made great strides now to where we have taken away some of the headache factor. So that was very important.

The other thing is while we are trying to improve the products, we are also doing some consumer awareness, authority in minority publications. Because as you know, sir, the minority home ownership lags far behind those of Anglos. And that is where we think we can do the most good.

Even though FHA is a good product, we want to make it a great product. With this marketing program in 44 markets nationwide, in African-American publications, Latino publications, it is already touting the many benefits, the here and now benefits of FHA.

Senator MARTINEZ. But if I understood it correctly, by your taking your market share, which has dropped from 12 to 3, back up to say 5, 8, 10, you are going to be serving a much broader and much larger number of first-time home buyers, which typically are going to be the least advantaged and the people that we are trying to get into ownership, and it will facilitate them doing so.

Mr. MONTGOMERY. Yes, sir, and those are exactly the borrowers we want to reach, the lower income, first-time home buyers.

Senator MARTINEZ. Thank you.

Senator ALLARD. I am going to put the Subcommittee in recess and we will be back, I estimate, in about 10 or 15 minutes.

In the meantime, I think we will just let the first panel go. We have some more questions, we have had a first round of questions. We will send those to you in the mail and then if you could respond within 10 days, we would appreciate it.

Thank you.

[Recess.]

Senator ALLARD. The Subcommittee will come back to order.

I want to apologize to the panel that we had to depart for a vote, but we are ready and looking forward to your testimony. We will start with Ms. Lowrie, and then we will move to Mr. Stevens, Mr. Pickel, Mr. Goldstein, and Mr. Petrou.

You are first, Ms. Lowrie.

STATEMENT OF REGINA M. LOWRIE, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

Ms. LOWRIE. Good afternoon, Mr. Chairman and members of the Committee. Thank you for holding this hearing and inviting me to share MBA's views on reforming the FHA.

In 1994, I founded Gateway Funding Mortgage with seven employees and $1.5 million in capital. We now have over 800 employees working in more than 58 offices and originating $3 billion in loans. I am proud of our work at Gateway and of my entire industry in providing home ownership opportunities for American families.

When I started Gateway, FHA programs helped us serve many borrowers who otherwise would not get a loan. Ten years ago, FHA comprised 40 percent of our volume. We worked hard to be a good partner with FHA and, together, FHA and Gateway served tens of thousands of home buyers.

Today, however, the story is very different. While Gateway has grown significantly, our use of the FHA program has dropped precipitously. While Gateway has adapted to changes in the market, FHA has not. While the needs of low- and moderate-income home buyers, of first-time home buyers, and of senior homeowners have changed, FHA has not followed its historic path of adapting to meet borrowers' changing needs.

MBA strongly supports FHA and believes that it still plays a critical role in today's marketplace. Most of FHA's business is directed toward low- and moderate-income and minority borrowers,

the very strata that is most challenged to be part of our ownership society.

At the same time, we have watched, with growing concern, as FHA has steadily lost market share over the past decade, potentially threatening its long-term ability to help underserved borrowers.

FHA was founded in 1934. Many of the laws, regulations, traditions that governed its operations have not kept pace with a rapidly changing and dynamic marketplace. As the market continues to innovate around FHA, the great fear is that many aspiring homeowners will either be left behind or forced into higher-cost alternatives.

We believe Congress should empower FHA to incorporate private sector efficiencies that will allow it to meet today's needs, and anticipate tomorrow's. MBA believes changes should be made in three areas. FHA needs more flexibility to introduce innovative new products, invest in new technology, and manage their human resources. MBA supports the Administration's proposals and the bills recently introduced by Senators Talent and Clinton to help FHA achieve these goals.

MBA supports changes to FHA's downpayment requirements, including the elimination of the complicated downpayment formula and rigid cash investment requirements. The downpayment is one of the primary obstacles for first-time minority and low-income home buyers.

FHA may be able to better serve borrowers and to do so with lower risk to their funds if they are able to adjust premiums based on the risk of each mortgage insured. We believe that FHA can develop a sound and simple premium structure that will be transparent to borrowers and insure that FHA is better matching the risk it is taking on with the premiums it is charging.

Finally, MBA supports all of the proposed changes to the home equity conversion mortgage program. MBA surveys show that FHA's HECM product comprises 95 percent of all reverse mortgages, and is thus tremendously important for our senior homeowners.

In conclusion, FHA has an important role to play in the market in expanding affordable home ownership opportunities for the underserved in addressing the home ownership gap. But the loss of market presence means we are losing FHA's impact. The result is that some families are either turning to more expensive financing or giving up.

MBA applauds the leadership and commitment of HUD Secretary Jackson, FHA Commissioner Montgomery, Senator Talent and Senator Clinton in calling for FHA reform. I urge Congress to enact legislation to reform FHA to increase its availability to home buyers, promote consumer choice, and insure its ability to continue serving American families.

Thank you for the opportunity to testify here today. We look forward to working with you on this important issue. Mr. Chairman.

Senator ALLARD. Thank you, Ms. Lowrie. Your timing was just perfect, you stayed within the 5-minute limit.

Mr. Stevens.

STATEMENT OF TOM STEVENS, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Mr. STEVENS. Good afternoon, Chairman Allard and Senator Reed and other Subcommittee members. My name is Tom Stevens, and I am the former president of Coldwell Banker Stevens, headquartered in Vienna, Virginia, serving the Washington-to-Baltimore market. And I am currently the 2006 president of the National Association of Realtors. I appreciate the opportunity to present the views of NAR's 1.3 million realtor members on the need to reform the FHA program.

As you know, FHA was established in 1934 to provide an alternative to the private market. From its inception, this program has played a vital role in the success and growth of home ownership in America. For more than 70 years, FHA has made mortgage insurance available to individuals regardless of their racial, ethnic, or social characteristics during periods of economic prosperity and economic depression.

Yet, despite its evident value, FHA's market share has dropped significantly in recent years. In the 1990s, FHA loans accounted for about 12 percent of the market. Today, that rate is closer to 3 percent. The decline in FHA mortgages has had a significant impact on America's home buyers. With FHA shrinking out of view, many home buyers have been left to consider more costly mortgage alternatives.

It is no coincidence that the market share of subprime loans has grown from 8.5 percent in 2002 to 20 percent just this past year. While such loans have a very important role to play for certain borrowers, there are many consumers who have taken out subprime loans when they would have qualified for FHA for a lower, overall cost.

Home buyers have also turned their attention to new types of specialty mortgages. Such mortgages include interest-only and option ARMs, which can be risky propositions to borrowers. These loans allow them to stretch their income so they can qualify for larger loans.

According to Moody's, more than a quarter of all existing mortgages come up for interest rate resets in 2006 and 2007. While some homeowners may be prepared to make the new higher payments, many will find it difficult, if not impossible.

NAR recently developed a specialty mortgage brochure to help Realtors discuss the risks and benefits of these mortgages with clients. And at this time, Mr. Chairman, I would like for permission to insert a copy of this into the record.

Senator ALLARD. Would you identify what this is?

Mr. STEVENS. This is a brochure that NAR has produced.

Senator ALLARD. So, it is a brochure from the National Association of Realtors?

Mr. STEVENS. Right.

Senator ALLARD. Without objection, so ordered.

What we need now is a viable alternative to these products. Minority home buyers are particularly vulnerable to high-cost loans. According to a recent study by the Center for Responsible Lending, minorities are 30 percent more likely to receive a higher-priced loan than white borrowers, even after accounting for risk. If made

competitive, FHA could once again provide an affordable alternative to predatory or discriminatory loans and help bridge the gap in minority home ownership.

To reform this program, we must address what caused the decline. Simply put, FHA's market share has dwindled because its loan limits, downpayments, and fee structure have not kept pace with the current mortgage marketplace. The Administration is proposing a number of important reforms to the FHA single-family insurance program that will greatly benefit home buyers nationwide.

First, FHA proposes eliminating the statutory 3 percent minimum cash investment and downpayment calculation. In 2005, 43 percent of the first-time home buyers financed 100 percent of their home. NAR research indicates that if FHA were allowed to offer this option, 1.6 million families would benefit.

By allowing both flexible downpayments and the flexibility pricing proposal, FHA could price such a product according to risk, as is done in the conventional market. Differentiating premiums based on the risk of the borrowers would permit FHA to reach higher-risk borrowers and charge borrowers with better credit risk less. Risk-based pricing is accepted practice in the private market. It should be for FHA, as well.

The Administration also proposed combining all single-family programs into the mutual mortgage insurance fund. In addition to combining the 203(k) and condominium programs under the MMIF, NAR also recommends that HUD be directed to restore investor participation in the 203(k) program. We also recommend that HUD lift the current owner-occupied requirement of 51 percent before individual condominium units can qualify for FHA-insured mortgages. The policy limits sales and home ownership opportunities, particularly in market areas with significant condominium developments and first-time home buyers.

Finally the Administration proposes increasing the FHA limits. The limits for single-family unit homes in high-cost areas would increase from $362,790 to the 2006 conforming loan limit of $417,000. In non-high-cost areas, the FHA limit, or floor, would increase from $200,160 to $271,050 for single unit homes.

Such increases are critical for FHA to assist home buyers in areas where home prices exceed the current maximum of $200,160, but are not defined as high-cost, such as Colorado, Florida, Pennsylvania, North Carolina, to mention a few.

Without such reforms to the FHA program, first-time home buyers, minorities, and home buyers with less than perfect credit, will continue to see fewer and fewer safe, affordable mortgage options. As we sit here today, interest rates are relatively low, home prices are rising, and lenders have expanded their pool of tools to offer borrowers. We must consider whether these options will still be available during periods of economic uncertainty.

FHA is the only national mortgage insurance program that provides financing to all markets at all times. NAR stands ready to work with you to craft legislation that furthers the mission of the FHA single-family mortgage insurance program, and make the dream of home ownership possible for even more families in the years to come. I thank you for the opportunity to testify.

Senator ALLARD. Mr. Pickel.

STATEMENT OF A.W. PICKEL, III, PRESIDENT AND CHIEF EXECUTIVE OFFICER, LEADERONE FINANCIAL CORPORATION, ON BEHALF OF THE NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Mr. PICKEL. Good afternoon, Chairman Allard and members of the Subcommittee. My name is A.W. Pickel, III. I am past president of the National Association of Mortgage Brokers (NAMB), and I am currently president of LeaderOne Financial Corporation in Kansas City. I am both a mortgage banker and a mortgage broker.

Thank you for inviting NAMB to testify today on FHA, issues for the future. As a voice of the mortgage brokers, NAMB speaks on behalf of more than 25,000 members in all 50 States and the District of Columbia. I want to commend this Subcommittee for its leadership on addressing the much needed reforms to the FHA program.

NAMB appreciates the opportunity to address the need to reform the FHA program to reduce the barriers to mortgage broker participation. And, two, increase FHA loan amounts for high-cost areas. We support many of the proposed reforms to the FHA program, but we believe the Administration should first make certain that the FHA loan program is a real choice for all prospective borrowers.

Regardless of how beneficial a loan product may be, it requires an effective distribution channel to deliver it to the marketplace. Unfortunately, many prospective borrowers are denied the benefits offered by FHA because mortgage brokers, the most widely used distribution channel in the mortgage industry, are limited in their ability to offer such products. Current FHA requirements impose cost-prohibitive, time-consuming, and unnecessary annual audit and net worth requirements on mortgage brokers who want to originate FHA loans. These requirements seriously impede mortgage brokers' ability to bring FHA loans to the marketplace.

A stated objective of both HUD and FHA is to increase origination of FHA loan products and expand home ownership opportunities for first-time, minority, and low- to moderate-income families. NAMB supports increased access to FHA loans so that prospective borrowers who may have blemished or almost nonexistent credit histories, or who can only afford minimum downpayments, have increased choice of affordable loan products, and are not forced by default to the subprime loan market.

The solution to increasing FHA loan production is relatively simple. Allow more mortgage brokers to offer FHA loan products directly to consumers. This could be accomplished by eliminating the audit and net worth requirements for mortgage brokers that want to offer these products to consumers. At a minimum, annual bonding requirements offer a better way to insure the safety and soundness of the FHA program than requiring originators to submit audited financial statements.

Congress and this Administration have made home ownership a priority in this country. Unfortunately, today, the demand for homes continues to outpace new housing development and sales of existing homes, causing escalation of home prices. In an environment of rising interest rates, many first-time, minority, and low- to moderate-income home buyers need the safer and less expensive financing options that the FHA program can provide.

For this reason, NAMB uniformly and unequivocally supports increasing FHA loan limits in high-cost areas. Congress should create the ability for FHA loan limits to be adjusted up to 100 percent of the local area median home price in all communities, thereby providing a logical loan limit that will benefit both the housing industry and the consumer. This approach allows the FHA loan limits to respond to changes in home prices and reflect a true home market economy. The benefits of the FHA program should belong equally to all taxpayers, especially those residing in high-cost areas that often are most in need for affordable financing options.

NAMB also supports eliminating the downpayment requirement and granting FHA the flexibility to offer 100 percent financing to aid in the effort to increase home ownership for first-time, minority, and low- to moderate-income families. This proposed reform will help significantly in achieving the Administration's stated goal of increasing minority home ownership by 5.5 million by 2010.

Congress should seize this opportunity to address these issues and revitalize the FHA program with this proposal. Borrowers will receive better loan programs and at lower interest rates. We strongly urge the Subcommittee to support these FHA reforms. NAMB appreciates the opportunity to offer you our views. I am happy to answer any questions and thank you very much.

Senator ALLARD. Mr. Goldstein.

STATEMENT OF IRA GOLDSTEIN, DIRECTOR OF POLICY AND INFORMATION SERVICES, THE REINVESTMENT FUND

Mr. GOLDSTEIN. Good afternoon, Senator, and thank you for the opportunity to offer my views today. My name is Ira Goldstein, and I am here from The Reinvestment Fund. The Reinvestment Fund is a national leader in the financing of neighborhood revitalization. Founded in 1985, TRF has invested $500 million for the creation and preservation of affordable housing, community facilities, commercial real estate, and renewable energy.

Our research in the areas of mortgage lending, foreclosure, and predatory lending has both a strong data base component, as well as a qualitative component that brings us personally in touch with the people from all quarters of the mortgage-lending process.

I speak today from what we have learned through those research endeavors. Home ownership is undeniably a critical component in the accumulation of wealth for most American families. Going forward, the demographic groups available to become homeowners are younger, lower income, and minority households. Those are the groups currently with the lowest home ownership rates. These are also the households that, statistically, have the least net worth.

So, many who have recently, and will in the future, become owners, are least able to weather the financial impact of the kinds of significant financial events that often occur with new homeowners. I think that it is worth considering the proposed changes to the FHA in the larger social context of whether we are approaching or have passed the peak societal benefit of home ownership.

As former Federal Reserve Governor Gramlich stated, and I quote, "there is a valid debate as to whether continuing to increase overall home ownership much further is feasible or even desirable." Legislation under consideration would seek to raise the home own-

ership rate through a variety of products and processes, essentially leveling the playing field so that FHA can effectively compete with the subprime mortgage market.

One such change is the zero downpayment mortgages. That is important because so few Americans are saving and household debt service ratios are currently at such high levels. The downpayment is a barrier to owning a home. The evidence seems to be fairly clear that those zero downpayment loans have a much higher probability of failure. Our review of foreclosures in the cities of Philadelphia and Baltimore and in the State of Delaware, suggests that people who purchased homes with two mortgages, one covering downpayment, were prominently represented among those in foreclosures.

According to reports from Fitch ratings, those products that we now call the exotic mortgages work well for higher net worth individuals seeking to manage their finances more advantageously. They are very risky for a person who is trying to afford a home for which they are only marginally qualified.

With respect to the proposal that FHA adopts a risk-based pricing approach, that is an idea that I think is certainly supportable, assuming that the models are properly conceived, developed, and monitored. The problematic part of the risk-based pricing model is that the price only compensates the lender for the risk the borrowers presents. In the end, assuming the model is correct, the lender and FHA can make money, even if some calculable percentage of borrowers default.

But that assumes that no one other than the borrowers and the lender matter. Research conducted by The Reinvestment Fund and Econsult Corporation that was commissioned by the Federal Reserve Bank of Philadelphia shows that there is a statistically demonstrable adverse effect of mortgage foreclosures on local property markets. In fact, after applying an appropriate set of statistical controls, we found that each foreclosure within an eighth of a mile of a sale, and 1 to 2 years prior to that sale, reduces the value of a home by 1 percent, at least.

In Philadelphia, the typical home has four to five foreclosures within the specified time and distance, so it is reduced by more than 5 percent. The implications of this is that everyone within the area has lost some wealth. This is not an argument against risk-based pricing. It is simply an argument to consider the social costs beyond those of the transaction.

My final points have to do with selling and servicing of loans. With respect to servicing, it is a well-settled fact that certain servicing and loss mitigation techniques increase the likelihood that a delinquent loan returns to paying status. For example, early intervention and reasonable access of the borrower to their servicer increases the chances that the loss to the investor is minimized.

The servicing and loss mitigation efforts on FHA loans are not the best. TRF's work with practitioners suggests that HUD has not enforced compliance with its current procedures. Even assuming they were complied with, the rules themselves have flaws.

Pennsylvania's Homeowners Emergency Mortgage Assistance Program, not currently available to people with FHA loans is a remarkably successful example of a loss mitigation strategy that in the case of the FHA could reduce claims against the insurance pool.

Servicing and loss mitigation take on added importance if FHA expands its current customer base as it has proposed.

There will be an added cost and added servicing burden undoubtedly passed on to the consumer, but that cost would likely be justified by increasing the likelihood that homeowners can keep their homes through financial hardships.

With respect to selling loans, our experience suggests strongly that changes that lower the threshold of entry or loosen the monitoring or accountability of mortgage brokers would be problematic. Brokers have, in most states, no fiduciary obligation to the borrower and their incentive structure is both unclear to borrowers, promotive of larger transactions, and does not necessarily incent locating the best transaction for borrowers.

First-time home buyers are oftentimes not equipped to understand that the broker, although paid by them, does not work for them the way you and I would use that phrase.

In closing, success for most American families is not just changing the rules so that FHA can originate more loans or compete with subprime lenders. Success would be that FHA replaces those products within the subprime mortgage market that disadvantage home buyers and homeowners with products and processes that enhance the likelihood of sustainable home ownership. Thank you.

Senator ALLARD. Mr. Petrou.

STATEMENT OF BASIL N. PETROU, MANAGING PARTNER, FEDERAL FINANCIAL ANALYTICS, INC.

Mr. PETROU. Thank you, Mr. Chairman. It is an honor to appear today before the Subcommittee to discuss the reform of the FHA single-family insurance program. I am managing partner of Federal Financial Analytics, a consulting firm that advises on U.S. legislative, regulatory, and policy issues affecting financial institutions and strategic planning.

I believe FHA needs reform, but the proposals currently under consideration by Congress would undermine FHA's mission and increase the risk to the insurance fund. As a Government program, FHA should serve its targeted borrowers if they are not already being adequately served by the private sector. It is not appropriate for FHA as a Government program to launch initiatives to expand its market share, per se.

FHA's market share has fallen along with for the traditional, privately insured mortgage market. But markets change. Recent TAO and HUD Inspector General reports, as well as the Presidents fiscal year 2007 budget raise serious questions about the mutual mortgage insurance funds financial soundness. We heard that this morning from GAO.

The most recent available MMI fund data show a serious reduction in the economic value of the fund. Mortgage market trends since then have shown significant weakening, as evidenced by recent guidance from the Federal Bank Regulatory Agency designed to protect insured depository institutions.

The FHA should not seek to grow its way out of its current financial problems. Doing so is reminiscent of the actions taken by distressed Savings and Loans during the 1980s. The MMI fund is already taking financial risks. For example, 50 percent of all FHA

loans insured in 2004 had downpayment assistance with nonprofit organizations that received seller funding accounting for 30 percent of these loans. GAO analysis indicates that these sellers raised the price of their properties to recover their contribution to the seller funded nonprofit, placing the FHA buyers and mortgages that were above the true market value of the home.

The IRS is curtailing these programs, but the significantly higher claim rates FHA has experienced from these loans will continue for those remaining on its books. Indicative of FHA's problems is that its delinquency rates are higher than those associated with prime loans and private subprime loans, adding yet more risk for chasing subprime borrowers with riskier products at this point in the mortgage market cycle could mean potentially profound losses for the FHA fund that will heighten the risk of calls upon the taxpayer.

From a budgetary perspective, the MMI fund now is only breaking even. Any shift in the MMI fund's financial condition will convert the program into a net cost to taxpayers, increasing the Federal budget deficit.

Raising FHA area loan limits, both the base limit and the high-cost area limit, will not help low- and moderate-income families to become homeowners. Raising the base limit would push the FHA-insured loan amount in low-cost areas to $271,000. And the income of borrowers qualifying for a mortgage of this size is over $86,000. Raising the high-cost limit would push the mortgage amount that could be insured by the FHA to $417,000, which could only be reached by borrowers with incomes over $132,000.

In key markets, raising the base limit would mean that the FHA not only would be targeting the higher-income borrowers in an area, but would also insure homes well above the median house price in an entire State.

Entire areas would become vulnerable to underwriting errors in the FHA program, potentially putting communities at serious risk of foreclosure. Raising the base limit to 65 percent of the GSE loan limit would set the base limit at a higher level than the current median existing house price for over 80 percent of the metropolitan areas reported by the Realtors.

This would further distance the FHA from its mission, as well as expose the MMI fund to increased risk from regional economic downturns. Giving FHA authority to replace its current premium structure with a risk-based premium is a very risky proposition. It raises serious questions about whether some low- and moderate-income borrowers and minorities will be priced out of the entire mortgage market. Further, GAO and HUD reports indicate that FHA does not have the necessary data or analytical capability to establish a successful risk-based premium.

A mispriced FHA premium structure would be devastating to the MMI fund and the borrowers it was meant to serve. Eliminating 3 percent minimum downpayment requirement must be carefully structured to prevent risk to borrowers, communities, and the rest of the MMI fund. Careful underwriting is critical for a pilot program.

The 100 percent Federal guarantee behind—these are my recommendations, now, for reform. They are not in the bill. The 100 percent FHA guarantee undercuts the financial health of the MMI

fund, provides incentives for lax underwriting, and is not needed to make FHA insurance useful for most of its targeted borrowers.

It is time that FHA became an income-targeted rather than a loan amount targeted housing program. The current system for setting FHA area limits is skewed toward raising these limits above the true median house price for an area, never lowering them, even if house prices fall. Income targeting FHA single-family program will assure that low- and moderate-income borrowers become the primary focus of the program. It should also make housing more affordable for these targeted borrowers. Thank you.

Senator ALLARD. Thank you for your testimony.

Now, let us see, we will have some time here for some questions from both Senator Reed and myself.

I understand that, Mr. Stevens, you need to get going here within a short period of time. So, Senator Reed is indicating that he does not have any specific questions for you, and I do not have any specific questions, although we do have questions that we will ask of the whole panel. And we will submit those to you, and if you could get the responses back to us within a 10-day period, I would appreciate it.

So, you were planning on leaving about 4:15 or so; is that correct?

Mr. STEVENS. I am supposed to be at another location at 4:15, so anytime that you will dismiss me, I would appreciate it.

Senator ALLARD. OK.

Do you have any questions, Senator for——

Senator CARPER. Not for Mr. Stevens.

Senator ALLARD. OK.

Very good, Mr. Stevens, just get a response in to us, if you would.

Mr. STEVENS. I will.

Senator ALLARD. Go ahead.

Mr. STEVENS. Thank you for your consideration.

Senator ALLARD. You are welcome.

OK. The first question I have is for all of the witnesses. As I indicated in my opening statement, we believe that one of the central questions that must be answered as a part of reforming FHA is, what is the role of the FHA, particularly *vis-a-vis* the private sector and low-income and first-time home buyers.

Ms. Lowrie, why don't you respond first, and we will give everybody else on the panel a chance to respond.

Ms. LOWRIE. Thank you, Mr. Chairman. Well, to speak to your question of the role of FHA, I think we can look at historically what FHA has done in consistently serving borrowers that were traditionally under-represented in the single-family mortgage market, particularly in the private sector.

I have been in the lending industry for 29 years and, up until about 15 years ago, FHA was the sole source of serving low- and moderate-income borrowers, first-time home buyers, minorities. When we look at statistics in 2004, 14.2 percent of FHA borrowers were African-Americans, compared with 5.4 percent of conventional borrowers. Hispanic borrowers made up about 15.3 percent of FHA loans, while they were only 8.9 percent of the conventional market.

And if we look at the overall home ownership rate being close to 70 percent—and I am not going to get into specifics to take up

time, but for Hispanics, African-Americans, low- and moderate-income borrowers, those numbers fall more in the line of the 50 percent range, 48–50 percent range.

So, there is definitely a need and we have definitely seen where FHA has served that market over the years. I think MBA has been calling for FHA reform for a number of years. To point out Mr. Petrou's concerns about the ability for FHA to manage risk-based pricing, that is one of the reasons why we think this reform is so critical, to improve their technology, improve their human resources, and improve their ability to be able to innovate new products to diversify their product line.

Senator ALLARD. Mr. Pickel.

Mr. PICKEL. Yes. Thank you, Chairman. I would say that if we do not change FHA, we are going to be hurting the very people that FHA should be serving.

When I started in the mortgage business in 1988, you had to have perfect credit and you had to have 5 percent down. Otherwise, you did not get a 5-percent down loan. With the advent of credit scoring, that changed. FHA, at that time, was the only one who allowed 3 percent down, was the only one who allowed gifts, and was the only one who took marginal credit.

If you want to know why FHA went from 12 percent to 3, it is because the GSEs started allowing gifts and doing 3 percent down, and subprime started taking over the marginal credit. That is not a bad thing. Those are good things. But we need to give FHA the freedom to adjust to the marketplace so they can help those people and give them 30-year fixed-rate mortgage loans so they can be there and they can be in the house. I have seen it.

The other thing is mortgage brokers today, if it is a one and two-person shop, they cannot afford an audit by a CPA for $15,000 to prove that they have $75,000 of net worth. So, if you go into a mortgage broker shop who cannot afford it, he or she is simply going to offer what they can, which is conventional or subprime. The lenders are still on the hook.

Some of the points—Regina and I talked about this earlier—FHA still holds that lender accountable for the underwriting of the file. The broker does not underwrite it. They simply are a distribution channel. Brokers need lenders as much as lenders need brokers.

Senator ALLARD. Mr. Goldstein.

Mr. GOLDSTEIN. Yes, Sir. Briefly, I would say that the role of the FHA has to be something more than just putting another product in the marketplace. There is plenty of product in the marketplace. It does not feel to me, nor does the research suggest, that there is a dearth of mortgage products, even in lower-income communities and in minority communities.

What there is a dearth of is good, safe products that people can use to purchase and refinance their mortgages so that they do not find themselves in a position of enhanced risk. The FHA could take a leadership role in that. But it is not by just putting out more product and becoming, essentially, some competitor with subprime lenders. It needs to be a market leader in terms of the best practices with respect to servicing loans, the best practices with respect to the selling channels of those loans, *et cetera*.

So again, it should not be just another product, it needs to be a good product. It needs a product leader in those markets.

Senator ALLARD. Mr. Petrou, do you have a response?

Mr. PETROU. I agree with Mr. Goldstein. The systems of the FHA at the current time really have to be improved. The servicing has to be improved. Just expanding to reach people at the very highest incomes is not going to do anything to bring in first-time home buyers or minorities into the program who are not otherwise going to be there.

The real issue, I think, is addressed by GAO. They have structural problems. They have systems problems. And if they expand without thinking about this—they are not qualified now to do a risk-based premium, according to the work the GAO and HUD IG have shown.

If they were to do that now, it could be devastating to the minorities in this country who would need FHA for their homes.

Senator ALLARD. Thank you for your responses.

Now I will call on Senator Reed for a question or two.

Senator REED. Thank you, Mr. Chairman.

Mr. Pickel, let me follow up an issue that I raised with Secretary Montgomery and that you alluded to, also, that is the notion of the impediments to an audit's financial statement. And this is the information received from HUD, their words, a submission of an audited financial statement that meets FHA's requirements effectively minimizes the insurance risk to FHA. Without this insurance, the risk to the FHA funds increases significantly because the financial viability of the approved lenders is undermined. This financial statement is also required by over half the states as a condition of obtaining a mortgage-broker license.

Furthermore, we have not found the cost of a financial audit to be a barrier for financially sound brokers to participate in our programs. For the past several years we continue to approve new brokers at a record rate. The percentage of brokers participating in our program have doubled from 30 percent in 1995, to 60 percent in 2005.

So, is this really a difficult issue for most brokers?

Mr. PICKEL. I believe it is. I cannot speak to their statistics because they are the ones who put those out. I cannot say that they are wrong or right. What I can tell you is that the brokers that I talk to, in response to the first thing, the audited net worth requirement is for $75,000. That may speak somewhat to the viability, but I would tell you that a bond, whereby there could be a pool of money that could be tapped upon, should there be something that occurs would be a much better deal than a financial statement.

In that audited financial they also allow furniture and fixtures. So, if you take about half of that out, really you are auditing someone for $15,000 to prove that they have about $40,000 in cash. That is never going to buy back a loan, even at the lower rates.

Second, brokers are only held accountable for fraud. We do not want the bad actors in the business, either. We want good actors. I am sure Regina can tell you, as a lender, she approves brokers and she does all the underwriting. All of the accountability, in terms of that loan buyback is held upon the lender and not the

broker. What we are asking is to get the broker channel out there so that more brokers can do that. We would suggest a bond, which would allow a better source of funds to go back against, if there is that need to go back against it.

Senator REED. Is Missouri one of those states that requires audit financial statements for a license?

Mr. PICKEL. You know, I am a mortgage lender and so I have audited financials, but I do not remember if they do for a broker. I do not think they do, at this point in time.

Senator REED. Mr. Goldstein.

Mr. GOLDSTEIN. Yes, Sir.

Senator REED. One of the issues that comes up is why, particularly low-income borrowers find themselves in the subprime market rather than with a competing and maybe a better product that the FHA market has—issues of advertising, steering, can you comment on that, based upon your research?

Mr. GOLDSTEIN. The research that we have done and that we have seen suggests that the way that this happens is the subprime products are actually just marketed much more aggressively than are the prime products or the FHA products.

And so, when there is a vacuum, that vacuum is taken up by that subprime market. The distribution channels are quite efficient and they make their way into the markets in a way that the FHA has not.

Senator REED. So, one thing that the FHA should think about is a more aggressive and effective marketing plan. Is that accurate?

Mr. GOLDSTEIN. Right. I would say that the lenders originating those FHA loans could consider that. And to be both appropriate and aggressive. I mean, one of the things that people complain about with respect to the subprime mortgages is that they are often marketed to people who are not, in fact, in search of money. And so they end up with a loan that they did not necessarily want or need.

Senator REED. Mr. Petrou, your comments on this issue of directing people to the FHA market versus the subprime market?

Mr. PETROU. Yes. I think that, you know, predatory lending, per se, is just wrong and that the bank regulators are doing what they can to try to go after it, and FHA should, as well. The traditional FHA product, properly underwritten has absolutely no problems if it is properly underwritten and properly priced.

So, the issue about marketing it, I can fully support that. The problem I have is that FHA does not know the risk it has on its books today.

Senator REED. But, just for clarification, there is a category of loans that are not predatory?

Mr. PETROU. Yes.

Senator REED. But there is a situation where a borrower could have done much better in an FHA versus a predatory product. And the presumption—at least, I think what FHA would like to see, is more of those people being aware of those products and taking advantage of it. Is that fair?

Mr. PETROU. Definitely. And our marketing program would be quite appropriate in that case.

Senator REED. Thank you very much.

Ms. Lowrie, there has been some discussion today, also, about the zero downpayment loans and other non-traditional loans. Can you give us your perspective on these products, when they are appropriate, should the FHA have these types of tools at their disposal?

Ms. LOWRIE. Yes, Senator, I can.

When we look at the demographics over the next decade and we look at the buyers that will be out there in the marketplace. A large percentage of those will be first-time home buyers. Some of them will be the first in their families to ever own a home. And we also know, through years of study and evidence, that the biggest obstacle is making a downpayment.

So, when we look at FHA competing in a marketplace, not to compete against the private sector, but to provide an opportunity to those first-time home buyers, the low- to moderate-income borrowers, minorities, the zero downpayment would afford them the opportunity to be able to get an FHA loan at a lower price than they would in the private sector.

In 2005, 43 percent of first-time home buyers used the zero downpayment. And I think when we look—and I cannot disagree that FHA needs reform in a lot of different areas, and we support that wholly. But we also, in addition to upgrading their technology and their human resources, they have to have the ability—and it is not just to introduce any new product. The zero downpayment product has been out in the marketplace for almost a decade now.

And we look at the need for FHA reform, a perfect example is the fact that it took almost 5 years for FHA to introduce a hybrid ARM because of the legislation and regulatory obstacles, that they operate within, almost, a strait jacket.

So I think, number one, the demographics, just to emphasize it again, the demographics show clearly that there is a need for a zero downpayment because of the increase in first-time home buyers over the next decade that we will be seeing.

And FHA has served the market of first-time home buyers and has had a history of serving that market for many, many years.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Senator ALLARD. Senator Reed, I think I will do another round, if it is OK with you.

Senator REED. Sure.

Senator ALLARD. I think Senator Carper is coming back.

OK. This is for Ms. Lowrie, Mr. Pickel, and Mr. Petrou.

In your testimony, each of you mentioned FHA in the context of its mission to serve low-income and first-time home buyers. Raising the FHA loan limit to 100 percent of the conforming loan limit would currently increase the loan limit to $417,000. A mortgage at this level would require an income of approximately $132,000 in order to qualify. Do you think someone of this income should be considered a low-income home buyer?

Ms. LOWRIE. Unfortunately, I never thought that I would sit here in the United States and call that a low-income home buyer. But when we look in so many markets throughout this country—I had the opportunity last year to participate in a Habitat for Humanity build in San Francisco in a townhouse in a low- to moderate-in-

come neighborhood that Habitat said those townhomes—and these are skinny, 1,500-square-foot townhomes that are going for $700,000.

There are so many areas in the country where unfortunately, because of the limits that FHA operates under, that first-time home buyers, whether they are policemen, firemen, teachers in the inner cities that cannot afford, that do not have the ability to get FHA financing because of FHA's loan limits.

It is a circumstance that I think we are all dealing with throughout this country in a lot of different areas.

Senator ALLARD. Mr. Pickel.

Mr. PICKEL. Well, while I wish everyone lived in Kansas City because our housing is much more affordable, that is not the case.

Senator ALLARD. What is the average home in Kansas City?

Mr. PICKEL. Actually, my average loan is about $130,000.

Senator ALLARD. And the average home in California must be around the $700,000, is that what you said?

Ms. LOWRIE. $700,000, yes. $500,000.

Senator ALLARD. Go ahead, Mr. Pickel.

Mr. PICKEL. I think our average sale price is about $190,000 but our average loan is $130,000.

I do not know if it is low income or not. All I do know is that in the high-cost markets, the only way for these people to buy a home that gets them a good interest rate, one that is fixed, that is not going to adjust, where the taxes and insurance are also put in the payment, is going to be through FHA.

And even when I spoke before the House, when they brought this up, one of the representatives stood up and said that $417,000 still would not touch what the cost of the homes were in that area.

So I think it only makes sense to me to go to that point and then give FHA the freedom to come up with products that are not risky, but allow people to get into homes. Because otherwise, they are going to get into a home with a 1-month ARM or a 228 that is going to adjust by seven points when it comes due. And then they are going to be out of that house.

So I think we have to let FHA go to that point and come up with some type of program that allows those people to get in.

Senator ALLARD. Mr. Petrou.

Mr. PETROU. The IRS data that is recently available for 2003 shows that roughly 79 percent of the people who filed tax returns with incomes over $100,000 showed that they took the mortgage interest deduction, which means that they had a house with a mortgage already, so they are not first-time home buyers, 85 percent paid State and local real estate taxes, which showed they had a home and probably some of them did not even have a mortgage.

So the same thing when you raise the base. If you raise the base to $270,000, you are talking about $86,000 mortgages, you are talking about 75 percent home ownership rates, according to what the IRS data shows.

You may be helping some people but you are not helping first-time home buyers.

Senator ALLARD. Thank you, and I will now go to Senator Carper.

Senator CARPER. Thank you, Mr. Chairman. Welcome. We are glad you are here. Thank you for joining us today and for your testimony in responding to our questions.

Is it Mr. Petrou?

Mr. PETROU. Petrou, yes.

Senator CARPER. Mr. Petrou, in your testimony, I think you mentioned a couple of reforms that you thought were appropriate. Could you just very briefly mention them again. And then I am going to ask, maybe starting with Ms. Lowrie and is it Mr. Pickel?

Mr. PICKEL. Just like sweet or dill.

Senator CARPER. There used to be a congressman named Jake Pickle. He spelled it wrong.

Mr. PICKEL. I am sure he did not, sir. He was out of Texas.

Senator CARPER. And Mr. Goldstein, I am going to just briefly ask you to just briefly respond to the reform proposals that Mr. Petrou has shared.

Mr. PETROU. Thank you, Senator.

I suggested that FHA become an income-targeted program instead of a loan price targeted program. And that way you could be assured that it was focused on people making—and I am not setting it at 100 percent of area median, 110, 95. That is for Congress to decide.

But the issue is once you target it to the median income of an area, you take into consideration the varying incomes across the country and make sure FHA is focused on those people, rather than, as for example in Mr. Pickel's case in Kansas City, where the $130,000 house, raising the base limit to $271,000 will be double the price of the median house prices in Kansas City. That is upper income people in that city. It is just the way it is.

The other thing I talked about was——

Senator CARPER. Would you all take a minute and just respond briefly to that idea. Ms. Lowrie.

Ms. LOWRIE. I guess my initial reaction to that, Senator, is that income limits will not improve the performance of the fund for FHA. I do not see how that would help that, at all. It would make it harder to actually improve the performance of the fund.

Senator CARPER. Mr. Pickel.

Mr. PICKEL. That was $130,000 loan amount, sales price $190,000, but close enough.

I think the issue I guess I would have is it makes FHA that much more cumbersome and FHA is cumbersome now.

And I do not think it also solves the problem.

Senator CARPER. Thanks. Mr. Goldstein.

Mr. GOLDSTEIN. I do not know if it is better or not, but I will say the one thing that I think that is interesting about it is what it does is it takes the emphasis away from allowing somebody to become essentially increasingly house poor and capping that.

So again, I do not know that it is better.

Senator CARPER. Mr. Petrou, you had a second——

Mr. PETROU. Yes, and that is to eliminate the 100 percent Federal insurance coverage on FHA loans. I mean, there is supposed to be a house and property behind these loans. The idea that the Federal Government has to insure 100 percent of the loan amount,

assuming that there is a house and some property there, makes no sense. It sends all the wrong incentives out to people.

As you know, FHA is plagued with fraud. It continues to have fraud. In my view, 100 percent insurance is one of the reasons it is prevalent with fraud.

Senator CARPER. And so your recommendation was?

Mr. PETROU. I want to have it reduced, tied to income. For example, and I will give you an example, the VA program does not have 100 percent Federal insurance. The VA program has insurance coverage which falls as the loan amount increases. It begins, I think, about 50 percent and then it goes down to 25 percent.

Senator CARPER. Again Ms. Lowrie, would you and Mr. Pickel and Mr. Goldstein just briefly respond to that recommendation?

Ms. LOWRIE. Yes, Senator.

First of all, I think that FHA has been in existence since 1934. We heard Commissioner Montgomery talk about today the revenue that it has brought to the U.S. Treasury. But also, when we look at what FHA has done to open doors for the American dream of home ownership to so many Americans, it has worked.

That, to me, is a much bigger broader discussion about Federal subsidies. We could talk about a lot of different Federal subsidies. But this is a program that has worked for years.

I will not disagree with Mr. Petrou that there has been an increase in fraud in the FHA program. But I will also say that there has been an increase of fraud against mortgage lenders across every segment of the market. In the private sector, in the GSE programs, in the subprime, in the Alt A, that fraud is an issue that we, as an industry, have to deal with. I have had meetings with the inspector general about it.

I do not necessarily think that by changing and lowering the amount of the insurance of the FHA program, that is going to decrease the fraud.

Senator CARPER. Thank you, ma'am.

Mr. Pickel, just a brief comment, please.

Mr. PICKEL. I think FHA was one of the most innovative programs that the Government came up with when they decided to do 100 percent insurance on the loan amount. It was the first time that any lender would ever decide to go and loan people money because they knew their risk was covered.

So I think, in taking that away, we are actually deciding that we are going to say FHA should not be innovative. Now they have not been innovative for 15 years. But by golly, in the beginning, they were.

So I think we should allow them to be innovative again. And I would not take it away.

Senator CARPER. Mr. Goldstein, could you briefly comment, please?

Mr. GOLDSTEIN. Briefly, I would say that what Mr. Petrou raised is an empirical question that we could figure out the answer to. And that is, econometrically, if you were to remove that 100 percent guarantee, would you adversely affect the market?

I do not think any of us here knows the answer to that question but it is a question that could be answered.

Senator CARPER. Mr. Chairman, my time is expired. Can I just ask——

Senator ALLARD. Go ahead and speak more. You missed the first round, so if you would like to speak more, that is fine.

Senator CARPER. Thanks very much.

This will probably be just for Mr. Goldstein, and if others feel really encouraged you can jump in, but this is really for Mr. Goldstein.

I think over the past decade or so homes have been really the primary method that a lot of families use to save money, as you know. Today, with interest rates starting to rise again and the threat of job losses, homeowners are in a somewhat more precarious situation, at least a lot of them are. If they lose their jobs and are unable to pay their mortgage they will maybe lose their homes which is, for a lot of folks, as I said, the primary source of their savings. And with the high interest rates, they may find it more difficult to get another home.

I think in your testimony, Mr. Goldstein, you may have mentioned that there are inadequacies in FHA's mitigation plans. I just want to ask if you can maybe comment a little bit more on what you believe those inadequacies to be.

Mr. GOLDSTEIN. Yes, sir. I was talking about the loss mitigation programs.

And there, what we have learned from our work with consumers and the like is the general rules that exist for loss mitigation, for servicing of the loans, have not been essentially complied with between the FHA borrowers and the FHA servicers. So that, for example, it is rare—in fact, I do not think I can ever remember an example of meeting with a borrower who said that they ever had their face-to-face meeting with their servicer when they got in trouble with their loan, which is a requirement.

I would also say that there were other such things in terms of the loss mitigation being made available only to those people who show immediately that they are able to again repay, rather than perhaps again repay within 30 or 60 or 90 days when they are reemployed.

So that there are certain aspects of the loss mitigation and the servicing, those two that are mentioned, that are frequently mentioned among borrowers.

Senator CARPER. Anything else you want to mention with respect to how to improve mitigation practices at FHA?

Mr. GOLDSTEIN. I would say that Pennsylvania, and I understand Delaware is contemplating something along these lines, has this homeowner's emergency mortgage assistance program, which was put in place back in the 1970s and was designed to ease that gap between the period of time when somebody, for example, lost a job as a result of a plant closing or a dramatic illness or something in that nature.

And under certain circumstances, the State of Pennsylvania will take a look at their circumstance. And if they consider that the circumstance that they are in is not of their own making and they are likely to come out of it, they will bring the mortgage current, put a silent second loan against their property, and at such time as they are required to pay back the State of Pennsylvania.

That program helps thousands of people a year. It is not a huge cost item to the State. In fact, in most ways, it is a revolving loan product.

Other states, like North Carolina, are taking a look at it. I understand there has been Federal legislation looking at something of that nature, and Delaware is looking at it, as well.

Senator CARPER. Let me just build on that, and this will be my last question.

There is a fellow in Delaware. His name is Henry Topel, T-o-p-e-l, who has probably reached the age a lot of people are thinking about slowing down, but he has no interest in that. He is a widower and in the past he has been involved in real estate and chaired a bank board.

But he is still active and thinks a lot about issues. He is one of those people who is not at all shy about sharing those ideas with guys like me, which I appreciate very much.

What he asked us to consider, and I will not do justice to what he suggested, but the plan would involve the creation of a fund modeled after the FHA program. And under the FHA program, home buyers would pay an additional, maybe half, percentage point for the FHA to insure their mortgage to private lenders.

Under his proposal, home buyers using the FHA program could elect to contribute another one-half percent to what he calls a reserve fund. And if the home buyer lost their job, they could draw down on this fund to cover mortgage payments until they were able to become gainfully employed. That is kind of a rough outline, maybe does not even do justice to what he suggests, but I think it does.

Do you have any initial thoughts or reactions to what he has shared? I would ask that you feel free to share any other programs you know that might serve to accomplish the same kind of goal, and that is to enable Americans—especially when they lose their jobs—to stay in their homes. Anybody?

Ms. LOWRIE. Senator, I will kind of jump in here.

I would be very interested to have MBA do a study and some research to look at how that might impact overall delinquencies. I would also like to submit MBA's most recent delinquency survey which was issued yesterday.

But I think there are insurance programs out there now for loss of job, medical illness, where maybe that is something that we might want to look at incorporating into the FHA programs, mandatory insurance. I am not sure that setting up a reserve fund, I would kind of put that in the same category as us talking about catastrophic insurance.

But I will, I do want to comment, back on the previous comments, about loss mitigation.

Senator CARPER. If you could do so just briefly because of the time.

Ms. LOWRIE. Real brief. And that is that FHA has been working very closely with all of the servicers to ensure active loss mitigation. And we have seen a decrease in delinquencies as a result of that strong enforcement of their loss mitigation.

Senator ALLARD. Ms. Lowrie, I am going to ask unanimous consent that your request be part of the record. Would you repeat it, what it is that you wanted? It was a survey——

Ms. LOWRIE. A survey of the impact of collecting a half percent for a reserve, for a loss reserve for loss of job.

Senator ALLARD. If you could submit that to the Committee, I will make that part of the record.

Senator CARPER. Thank you. Thanks, Mr. Chairman.

Mr. Pickel, any initial reaction to what Mr. Topel has raised?

Mr. PICKEL. I think loss mitigation and early intervention are one of the best things we can do, especially for people with low-to-moderate income who are new at buying a house. They are used to renting. It is a whole new ball game.

There are a couple of ideas that come to mind, and I do not know how you would implement these. But one would be where you would allow them to skip a payment. Part of that some lenders already do now, where they put it onto the end of the mortgage.

But other things like that, to gradually build people in. If you can get people into that home for a year and help them for that first year, which is the most crucial period, I think that would be the best.

In my own shop, we actually call people, and it is not a threatening call. We simply call and say hey, how is it going? We want to know. We actually call every single month the first year on all FHA loans.

Senator CARPER. Do you really? Wow. Thank you.

Mr. Goldstein.

Mr. GOLDSTEIN. What Mr. Pickel just mentioned I think is a very interesting thing because the data does very clearly show that the earlier that you intervene with somebody who is in difficulty with their loan, there is a much greater likelihood in terms of them becoming current again.

With respect to Mr. Topel's idea, it is an interesting concept because generally speaking the people that we are talking about are people who have made a zero downpayment, or very close to a zero downpayment. And the reason they did it was not to save their savings, but because they did not have savings.

And so, the ability to be able to have something to draw upon, I think represents quite an interesting idea.

Senator CARPER. Thank you. Mr. Petrou.

Mr. PETROU. It could be changed a bit, I think, to focus it on a rather narrow target, which is a group of very low- and moderate-income in the area.

My concern is with the FHA because I am not sure that they have the financial wherewithal at this time to start expanding into an area like that, which is actually a separate risk category for them. So that is my only reserve. But the pricing might also be an issue.

Senator CARPER. My thanks to each of you.

Mr. Chairman, you have been very generous with the time. Thank you so much.

Senator ALLARD. Thank you, Senator Carper.

I do have more questions, and perhaps other members on the Committee have more questions. I would ask that you respond to

those within 10 days after we submit them to you, if you would, please.

In the meantime, I have a closing statement that I am going to make here.

Once again, I would like to thank all of our witnesses for being here today. Your testimony touched on a number of important points and we had a productive question and answer period.

I appreciate this opportunity to hear these perspectives as the Subcommittee considers the future of a program that has been so helpful in allowing low-income and first-time home buyers to experience the American dream of home ownership.

Because there are still so many unanswered questions regarding the role of FHA and the effect of the proposed reforms, along with Senator Shelby I plan to commission a GAO study. We will ask GAO to examine the major factors underlying the decline in FHA's market share, the financial and public policy implications of the decline in market share, the extent and areas of overlap between types of borrowers served by FHA and other markets, the most viable options FHA could pursue to serve additional low-income and first-time home buyers, the implications of the reform proposal before us.

This study will provide the fact that we need to reform FHA in an informed, responsible manner that will ensure it continues to be viable for years to come.

The record will remain open for 10 days should members wish to submit any additional questions to the witnesses. Witnesses, we would appreciate your prompt response to the questions, and would ask you to please respond to them within 10 days.

Thank you to everyone for attending this hearing of the HousING and Transportation Subcommittee.

The hearing is adjourned.

[Whereupon, at 4:45 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF RICK SANTORUM

A SENATOR FROM THE STATE OF PENNSYLVANIA

JUNE 20, 2006

Mr. Chairman, I appreciate you holding this hearing today on the important subject of reform of the Federal Housing Administration (FHA). FHA has enabled many Americans to become homeowners who may otherwise not have been able to buy homes. FHA does this by providing Federal insurance on the loans made by private lenders. Because lenders are protected against borrowers defaulting, FHA has made mortgages available to more Americans, particularly for low-income borrowers.

In recent years, the FHA market share has dropped significantly. This hearing will examine some proposals that have been put forward to address this drop in market share.

I am particularly pleased that we have two witnesses from Pennsylvania testifying.

Ms. Regina Lowrie is the Chairman of the Mortgage Bankers Association and brings her expertise in the mortgage market and in working with FHA to bear on this important topic. Her company, Gateway Funding Diversified Mortgage Services, has seen their ability to use the FHA programs drop markedly. I appreciate her insight into what changes her organization thinks are necessary for FHA to regain some of their market share and positively impact home ownership rates.

Mr. Ira Goldstein is the Director of Policy and Information Services for The Reinvestment Fund (TRF) in Philadelphia. I have worked with TRF for several years now and am proud of their thoughtful and data-based contribution to neighborhood revitalization. TRF has done a lot of work looking at the factors that lead to mortgage foreclosures and the lasting impact of such foreclosures on neighborhoods. I believe Mr. Goldstein provides a proper cautionary note that while we seek to increase our home ownership rates, we should do so in ways that lead to sustainable home ownership for people who are truly ready to own and maintain their homes over the long-term, even through the financial hardships that may come their way.

I welcome them both to the Committee, and look forward to hearing their testimony.

PREPARED STATEMENT OF BRIAN D. MONTGOMERY

ASSISTANT SECRETARY FOR HOUSING AND FEDERAL HOUSING COMMISSIONER
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

JUNE 20, 2006

Thank you Chairman Allard and Ranking Member Reed for inviting me to be here today to testify on the Administration's proposed FHA Modernization Act.

As you are all aware, the Federal Housing Administration (FHA) was created in 1934 to serve as an innovator in the mortgage market, to meet the needs of citizens otherwise underserved by the private sector, to stabilize local and regional housing markets, and to support the national economy. This mission is still very relevant, perhaps now more so than ever.

Moreover, the FHA model represents the very best of what government can and should do. Since its inception, FHA has helped more than 34 million Americans become homeowners. By operating through a private distribution network, FHA efficiently reaches families in need of safe and affordable home financing. Simply put, FHA insurance protects lenders against loss, enabling these private sector partners to offer market-rate mortgages to home buyers who would otherwise remain unserved or underserved. FHA provides a substantial benefit to families, communities, and the entire national economy.

We believe that FHA should continue to play a key role in the national mortgage market and I'm here today to make the case for changes to the National Housing Act that will permit us to continue to fulfill our critical mission.

Let me explain. In recent years, FHA's outdated statutory authority has left the agency out of synch with the rest of the lending industry. Over the last decade, the mortgage industry transformed itself, offering innovative new products, risk-based pricing, and faster processing with automated systems. Meanwhile, FHA continued to offer the same types of products with the same kinds of pricing, becoming less attractive to lenders and borrowers alike.

As a result, FHA's business has dropped precipitously in housing markets all across the nation. For example, in Chairman Allard's home State of Colorado, FHA's volume has dropped from 42,609 loans in 1999 to 18,543 loans in 2005. For Ranking Member Sarbanes, during that same time period, FHA's volume in Maryland

dropped from 61,201 to 11,824 loans. And for Ranking Member Reed, FHA's volume in Rhode Island is down from 4,695 loans in 1999 to just 906 loans in 2005.

FHA has fallen behind for a variety of reasons, from outdated business practices to cumbersome program requirements. Over the last 9 months, we have made significant changes, streamlining and realigning FHA's operating procedures. While these changes are good and long overdue, they are not enough, a point that FHA's industry partners have clearly conveyed. Therefore, FHA is now requesting that we amend the law to give FHA the flexibility it needs to fulfill its original mission in today's marketplace.

As the dynamic mortgage market passed FHA by, many home buyers—first-time home buyers, minority home buyers and home buyers with less-than-perfect credit—were left with fewer safe and affordable options. Many of them became home buyers, but paid a steep price to do so, especially those living in higher-cost states, such as California, New York, Rhode Island, and Massachusetts, to name a few.

Without a viable FHA alternative, many home buyers turned to high-cost financing and nontraditional loan products to afford their first homes. While low initial monthly payments seemed like a good thing, the reset rates on some interest-only loans are substantial and many families are unable to keep pace when the payments increase. In addition, prepayment penalties make refinancing cost-prohibitive. According to Moody's *Economy.com,* more than $2 trillion of U.S. mortgage debt, or about a quarter of all mortgage loans outstanding, comes up for interest rate resets in 2006 and 2007. While some borrowers will make the higher payments, many will struggle. Some will be forced to sell or lose their homes to foreclosure. The foreclosure rate for subprime loans is twice that of prime loans. And I think we can all agree that foreclosures are bad for families, bad for neighborhoods, and bad for the economy as a whole.

That said, the FHA Modernization Act is part of the solution. FHA reform is designed to give home buyers who can't qualify for prime financing a choice again.

Moreover, the FHA bill proposes changes that will strengthen FHA's financial position, improving FHA's ability to mitigate and compensate for risk. The proposed changes would permit FHA to operate like every other insurance company in the nation, pricing its products commensurate with the risk, as opposed to having some clients pay too much and some too little. Imagine if a car insurance company charged all clients the same premium—the 17-year-old teenager and a 40-year-old adult would pay the same rate. Is that fair? With a blended rate, those who know they're paying too much find themselves another insurance company. That leads to a portfolio that is increasingly lopsided: too many riskier borrowers, too few safer borrowers, and an insurance fund that poses a risk of default. This type of adverse selection is exactly what happened to FHA over the last decade. Those who were lower credit risks went elsewhere. The premium changes proposed in the bill will restore balance to the FHA funds, providing appropriate levels of revenue to operate in a more fiscally sound manner.

I know my introduction was lengthy, but I want you to understand how important FHA reform really is—for FHA, for the home buyers we serve, and for the industry as a whole. FHA's private sector partners—the brokers, the realtors, the lenders, the home builders—want to tell their clients about the FHA alternative. They want low- to moderate-income home buyers to have a safer, more affordable financing option. They want FHA to be a viable player again.

Now let me explain a little bit about the simple changes we're proposing. For one, we're proposing to eliminate FHA's complicated downpayment calculation and 3 percent cash investment requirement. Before the rest of the market began offering low downpayment loans, FHA was often the best option for first-time home buyers because it required only a minimal downpayment. But, as I said before, the market passed FHA by. Last year, 43 percent of first-time home buyers purchased their homes with *no* downpayment. Of those who did put money down, the majority put down 2 percent or less.

The downpayment is the biggest barrier to home ownership in this country, but FHA has no way to address the barrier without changes to its statute. The FHA Modernization Act proposes to permit borrowers to choose how much to invest, from no money down to one or two or even 10 percent.

The bill also proposes to provide FHA the flexibility to set the FHA insurance premiums commensurate with the risk of the loans. For example, no downpayment loans would be priced slightly higher, yet appropriately, to give home buyers a fairly priced option and to ensure that FHA's insurance fund is compensated for taking on the additional risk. FHA would also consider the borrower's credit profile when setting the insurance premium. FHA would charge lower-credit risk borrowers a lower insurance premium than it does today, and higher-credit risk borrowers would be charged a slightly higher premium. In so doing, FHA could reach deeper into the

pool of prospective borrowers, while protecting the financial soundness of the FHA Fund.

A slightly higher premium would increase a borrower's monthly payment only minimally. For example, on a $200,000 loan, a 1 percent upfront premium financed into the loan would cost the borrower $12.64 per month; a 2 percent premium would cost $25.28 and a 3 percent premium, $37.92. Clearly, this higher premium is still affordable. Moreover, it's a smart investment, because the borrower is paying for the FHA insurance to obtain a market rate loan.

The primary concerns with a risk-based pricing approach are that FHA will target people who shouldn't be home buyers and charge them more than they should pay. I want to address these concerns directly. Our goal is to reach families who are capable of becoming homeowners and to offer them a safe and fairly priced loan option.

With a risk-based premium structure, FHA can reach hard-working, credit-worthy borrowers—such as store clerks, bus drivers, librarians, and social workers—who, for a variety of reasons, do not qualify for prime financing. Some have poor credit scores due to circumstances beyond their control, but have put their lives back together and need a second chance. For some, the rapid appreciation in housing prices has simply outpaced their incomes. Many renters find it difficult to save for a downpayment, but have adequate incomes to make monthly mortgage payments and do not pose a significant credit risk. They simply need an affordable financing vehicle to get them in the door. FHA can and should be there for these families.

The higher premiums that FHA will charge some types of borrowers are still substantially lower than they would pay for subprime financing. Let me repeat that point: the higher premiums that FHA will charge some types of borrowers are still substantially lower than they would pay for subprime financing. The cost of a loan with a higher FHA insurance premium is still substantially lower than the cost of a loan with a higher interest rate. For example, if FHA charged a 3 percent upfront insurance premium for a $200,000 loan to a credit-impaired borrower versus that same borrower obtaining a subprime loan with an interest rate 3 percent above par, the borrower would pay over $255 more in monthly mortgage payments with the subprime loan and over $125,000 more over the life of the loan, if they kept it for a full 30-year term.

Moreover, as I stated earlier, FHA intends to lower the insurance premium for many borrowers. FHA will charge lower-risk borrowers a substantially lower premium than these types of borrowers pay today. For example, home buyers with higher credit scores who choose to invest at least 3 percent in a downpayment may pay as little as half a percent upfront premium.

So, while FHA may charge riskier borrowers more (and less risky borrowers less) than it does today, the benefit is three-fold. First, FHA will be able to reach additional borrowers the agency can't serve today. There is nothing that upsets us more than to see people taken to the cleaners when they would have fared better with an FHA-insured product. Second, these borrowers will pay less with FHA than with a subprime loan. And finally, the FHA Fund will be managed in a financially sound manner, with adequate premium income to cover any losses.

Another change proposed in the FHA Modernization Act is to increase FHA's loan limits. Members of Congress from high-cost states have repeatedly asked FHA to do something about our antiquated loan limits. This bill finally answers their concerns. FHA's loan limit in high-cost areas would rise from 87 to 100 percent of the GSE conforming loan limit and in lower-cost areas from 48 to 65 percent of the conforming loan limit. In between high- and lower-cost areas, FHA's loan limit will increase from 95 to 100 percent of the local median home price. This change is extremely important and crucial in today's housing market. In many areas of the country, the existing FHA limits are lower than the cost of new construction. Buyers of new homes can't choose FHA financing in these markets. In other areas, FHA has simply been priced out of the market. For example, in 1999, FHA insured 127,000 loans in the State of California; in 2005, FHA-insured only 5,000.

FHA is also proposing some changes to specific FHA products. For example, the bill proposes to permit FHA to insure mortgages on condominiums under its standard single-family product. The existing condo program is very specialized and burdensome, as a result of outdated statutory provisions that were written at a time when condominiums were an unfamiliar form of ownership. Condos represent 25 percent of the new, and 12 percent of the existing, home market today and serve as one of the primary forms of affordable housing for first-time home buyers. In fact, condos tend to be closer to city centers and offer lower-income borrowers an opportunity to buy an affordable home without moving far from their jobs and away from the public transportation that gets them to those jobs. Therefore, FHA should be

able to serve condo buyers, just like any other home buyers, under its standard single-family program.

Our reform bill also proposes to modernize the Title I manufactured housing program, eliminating the portfolio insurance feature from the program and increasing the loan limits to reflect the real cost of manufactured housing today. The existing statute restricts FHA claim payments to 10 percent of the value of a lender's loan portfolio. With portfolio insurance, lenders are not guaranteed coverage against loss and subsequently price their loans for additional risk. The higher loan costs, in turn, increase the likelihood of borrower default. With additional default risk, but insufficient coverage, the losses grew to unsustainable levels in the 1990s and Ginnie Mae pulled out of the program. Ginnie Mae has testified that with the elimination of this outdated insurance model it would reconsider participation in the Title I securities market, which will bring in more lenders and drive down the costs of manufactured home financing.

Finally, the FHA Modernization Act offers some changes to the Home Equity Conversion Mortgage (HECM) program, which enables senior homeowners, aged 62 years or older, to tap into their home equity to live comfortably in their golden years. The bill proposes elimination of the cap on the number of loans FHA can insure; a single, national loan limit set at conforming; and a new HECM for Home Purchase product to permit seniors to move from the family home to more suitable senior housing and convert the purchase loan into a HECM in a single transaction. Today, seniors who want to move, but need additional cash-flow to pay their living expenses, must purchase a new home and take out a HECM in two distinct transactions, resulting in two sets of loan fees and charges.

Let me repeat a point I made earlier in the testimony. I want to assure you that the changes we are proposing will not increase the overall risk of the MMI Fund or impose a potential cost on taxpayers. We are proposing to manage the Fund in a financially prudent way, beginning with the change in FHA pricing to match premiums with risk. This will avoid FHA being exposed to excessive risk, as it is today, because some borrowers who use FHA are under-charged for their risk to the Fund while others are overcharged. Of course, we will continue to monitor the performance of our borrowers very closely, and make adjustments to underwriting policies and/or premiums as needed.

I know I've talked a lot here today, but I want to convey to you how passionate I am about the proposed changes. I believe we have an opportunity to make a difference in the lives of millions of low- and moderate-income Americans. We have a chance to bring FHA back into business, to restore the FHA product to its traditional market position. To all those families who can buy a home with prime conventional financing, I say, "Go for it!" They're fortunate and they should take full advantage of that benefit. But for those who can't, FHA needs to be a viable option. And when people ask me why are we proposing these changes, I tell them these exact words: "Families need a safe deal, at a fair price. Families need a way to take part in the American Dream without putting themselves at risk. Families need FHA."

I want to thank you again for providing me the opportunity to testify here today on the FHA Modernization Act. I look forward to working with all of you to make these reforms a reality.

PREPARED STATEMENT OF WILLIAM B. SHEAR

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JUNE 20, 2006

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, United States Senate

For Release on Delivery
Expected at 2:30 p.m. EDT
Tuesday, June 20, 2006

FEDERAL HOUSING ADMINISTRATION

Proposed Reforms Will Heighten the Need for Continued Improvements in Managing Risks and Estimating Program Costs

Statement of William B. Shear, Director
Financial Markets and Community Investment

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Highlights

Highlights of GAO-06-868T, a testimony before the Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, United States Senate

Why GAO Did This Study

The Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) has faced several challenges in recent years, including rising default rates, higher-than-expected program costs, and a sharp decline in program participation. To help FHA adapt to market changes, HUD has proposed a number of changes to the National Housing Act that would raise FHA's mortgage limits, allow greater flexibility in setting insurance premiums, and reduce down-payment requirements. Implementing the proposed reforms would require FHA to manage new risks and estimate the costs of program changes. To assist Congress in considering issues faced by FHA, this testimony provides information from recent reports GAO has issued that address FHA's risk management and cost estimates. Specifically, this testimony looks at (1) FHA's development and use of its mortgage scorecard, (2) FHA's consistent underestimation of program costs, (3) instructive practices for managing risks of new mortgage products, and (4) weaknesses in FHA's management of risks related to loans with down-payment assistance.

www.gao.gov/cgi-bin/getrpt?GAO-06-868T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

June 20, 2006

FEDERAL HOUSING ADMINISTRATION

Proposed Reforms Will Heighten the Need for Continued Improvements in Managing Risks and Estimating Program Costs

What GAO Found

Recent trends in mortgage lending have significantly affected FHA, including increased use of automated tools (e.g., mortgage scoring) to underwrite loans, increased competition from lenders offering low-and no-down-payment products, and a growing proportion of FHA-insured loans with down-payment assistance. Although FHA has taken steps to improve its risk management, in a series of recent reports, GAO identified a number of weaknesses in FHA's ability to manage risk and estimate program costs during this period of change. For example:

- The way that FHA developed and uses its mortgage scorecard, while generally reasonable, limits how effectively it assesses the default risk of borrowers.
- With one exception, FHA's reestimates of program costs have been less favorable than originally estimated, including a $7 billion reestimate for fiscal year 2003.
- FHA has not consistently implemented practices used by other mortgage institutions to help manage the risks associated with new mortgage products.
- FHA has not developed sufficient standards and controls to manage risks associated with insuring a growing proportion of loans with down-payment assistance.

GAO made several recommendations in its recent reports, including that FHA (1) incorporate the risks posed by down-payment assistance into its mortgage scorecard, (2) study and report on the impact of variables not in its loan performance models that have been found to influence credit risk, and (3) consider piloting new mortgage products. FHA has taken actions in response to GAO's recommendations, but additional improvements in managing risk and estimating program costs will be important if FHA is to successfully implement its proposed program changes.

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to share information and perspectives with the committee as it considers issues facing the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). FHA provides insurance for single-family home mortgages made by private lenders and in fiscal year 2005 insured about 480,000 mortgages, representing $58 billion in mortgage insurance. The insurance program is supported by the Mutual Mortgage Insurance Fund (Fund), which is financed through insurance premiums that FHA charges to borrowers. According to HUD's estimates, FHA's mortgage insurance program is currently a negative subsidy program, meaning that the Fund is self-financed and currently operates at a profit. However, the program has faced several challenges in recent years, including rising default rates, higher-than-expected program costs, and a sharp decline in program participation due, in part, to increased competition from conventional mortgage providers.

To help FHA adapt to market changes, HUD has proposed a number of changes to the National Housing Act that would, among other things, raise FHA's maximum mortgage limits, give the agency flexibility to set insurance premiums based on the credit risk of borrowers, and reduce down-payment requirements from the current 3 percent to potentially zero. However, to implement this legislative proposal, FHA would have to manage new risks and accurately estimate the costs of program changes. For example, to set risk-based insurance premiums, FHA would need to understand the relationships between borrower and loan characteristics and the likelihood of default, as well as how the premiums would affect the Fund's financial condition. Further, reducing the down-payment requirements for certain borrowers (and thus increasing the loan-to-value ratios) has important implications for the risks of these loans. Loans with low or no down payments carry greater risk, partly because the higher the loan-to-value ratio, the less cash borrowers will have invested in their homes and the more likely that they may default on mortgage obligations, especially during times of economic hardship.[1]

My testimony today discusses four reports that we issued since 2005 that examined different aspects of FHA's ability to manage risks and estimate

[1]Loan-to-value ratio is the loan amount divided by the sales price or appraised value of the property.

program costs. Specifically, I will discuss (1) FHA's development and use of a mortgage scorecard to assess the default risk of borrowers, (2) FHA's consistent underestimation of subsidy costs for its single-family insurance program and particularly large subsidy reestimate for fiscal year 2003, (3) practices that could be instructive for FHA in managing the risks of new mortgage products, and (4) weaknesses in how FHA has managed risks associated with growth in the proportion of loans with down-payment assistance.

In preparing these reports, we reviewed and analyzed information concerning FHA's approach to developing its mortgage scorecard and the scorecard's benefits and limitations; FHA's estimates of subsidy costs and the factors underlying the agency's subsidy reestimates; steps mortgage industry participants take to design and implement low- and no-down-payment mortgage products; and the standards and controls FHA uses to manage the risks of loans with down-payment assistance. We interviewed officials at FHA, the U.S. Department of Agriculture, and U.S. Department of Veteran Affairs (VA); and staff at selected mortgage providers, private mortgage insurers; Fannie Mae and Freddie Mac; the Office of Federal Housing Enterprise Oversight; selected state housing finance agencies; and nonprofit down-payment assistance providers. We conducted this work in Boston, Massachusetts, and Washington, D.C., from January 2004 through February 2006 in accordance with generally accepted government auditing standards.

In summary, our past work identified a number of weaknesses in FHA's ability to manage risk and estimate program costs:

- While generally reasonable, the way that FHA developed and uses its mortgage scorecard—an automated tool that evaluates the default risk of borrowers—limits the scorecard's effectiveness. FHA and its contractor used variables that reflected borrower and loan characteristics to create the scorecard, as well as an accepted modeling process to test the variables' accuracy in predicting default. However, the data used to develop the scorecard were 12 years old by the time that FHA began using the scorecard in 2004, and the mortgage market has changed significantly since then. In addition, the scorecard does not include certain key variables that could help explain expected loan performance such as the source of the down payment.

- FHA's subsidy reestimates reflect a consistent underestimation of the costs of its single-family insurance program. For example, as of the end of fiscal year 2003, FHA submitted a $7 billion reestimate for the Fund,

reflecting a reduction in estimated profits. Increases in the expected level of insurance claims—potentially stemming from changes in underwriting guidelines, among other factors—were a major cause of the $7 billion reestimate.

- Some of the practices of other mortgage institutions offer a framework that could help FHA manage the risks associated with new products such as no-down-payment mortgages. For example, mortgage institutions may limit the volume of new products issued—that is, pilot a product—and sometimes require stricter underwriting on these products. While FHA has utilized pilots or demonstrations when making changes to its single-family mortgage insurance, it generally has done so in response to a legislative requirement and not on its own initiative. Moreover, FHA officials have questioned the circumstances under which pilot programs were needed and also said that they lacked sufficient resources to appropriately manage a pilot.

- FHA has not developed sufficient standards and controls to manage risks associated with the growing proportion of loans with down-payment assistance. Unlike other mortgage industry participants, FHA does not restrict homebuyers' use of down-payment assistance from nonprofit organizations that receive part of their funding from home sellers. However, our analysis of a national sample of FHA-insured loans found that the probability that loans with seller-funded nonprofit down-payment assistance would result in an insurance claim was 76 percent higher than comparable loans without such assistance.

On the basis of our findings from the four reports I have summarized, we made several recommendations designed to improve FHA's risk management and cost estimates. For example, to improve its assessment of borrowers' default risk, we recommended that FHA develop policies for updating the scorecard, incorporate the risks posed by down-payment assistance into the scorecard, and explore additional uses for this tool.

To more reliably estimate subsidy costs, we recommended that FHA study and report in the annual actuarial review of the Fund the impact of variables not in the agency's loan performance models (used in estimating subsidy costs) that have been found in other studies to influence credit risk.[2] In light of the risks that new mortgage products present and in

[2]Since 1990, the National Housing Act has required an annual and independent actuarial analysis of the economic net worth and soundness of the Fund. 12 U.S.C. Section 1711 (g).

recognition of established risk management practices, we also suggested that Congress consider (1) limiting the initial availability of any new single-family insurance product it might authorize and (2) directing FHA to consider using various techniques for mitigating risks for a no-down-payment product, or products about which the risks were not well understood.

FHA has taken actions in response to some of our recommendations. For example, FHA agreed to consider incorporating a variable for down-payment assistance in its mortgage scorecard. To more accurately assess subsidy costs, an FHA contractor is considering the specific variables that we recommended FHA include in its annual actuarial review and incorporated the source of down payment in the 2005 actuarial review of the Fund. FHA also has agreed to improve its oversight of down-payment assistance lending, including modifying its information systems to document assistance from seller-funded nonprofits.

While these actions represent improvements in FHA's risk management, additional improvements will be important if FHA is to successfully implement some of the program changes HUD has proposed. Accordingly, consideration of this proposal should include serious deliberation of the associated risks and the capacity of FHA to mitigate them.

Background

Congress established FHA in 1934 under the National Housing Act (P.L. 73-479) to broaden homeownership, shore up and protect lending institutions, and stimulate employment in the building industry. FHA's single-family program insures private lenders against losses (up to almost 100 percent of the loan amount) from borrower defaults on mortgages that meet FHA criteria. In 2004, more than three-quarters of the loans that FHA insured went to first-time homebuyers, and more than one-third of these loans went to minorities. From 2001 through 2005, FHA insured about 5 million mortgages with a total value of about $590 billion. However, FHA's loan volume fell sharply over that period, and in 2005 FHA-insured loans accounted for less than 4 percent of the single-family mortgage market, compared with about 13 percent a decade ago. Additionally, default rates for FHA-insured mortgages have risen steeply over the past several years, a period during which home prices have appreciated rapidly and default rates for conventional and VA-guaranteed mortgages have been relatively stable.

FHA determines the expected cost of its insurance program, known as the credit subsidy cost, by estimating the program's future performance.[3] Similar to other agencies, FHA is required to reestimate credit subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. FHA's mortgage insurance program is currently a negative subsidy program, meaning that the present value of estimated cash inflows to the Fund exceed the present value of estimated cash outflows. FHA has estimated that the loans it expects to insure in 2007 will have a subsidy rate of -0.37, a rate closer to zero (the point at which estimated cash inflows equal estimated cash outflows) than any previous estimate. The economic value, or net worth, of the Fund that supports FHA's insurance depends on the relative size of cash outflows and inflows over time. Cash flows out of the Fund for payments associated with claims on defaulted loans and refunds of up-front premiums on prepaid mortgages. To cover these outflows, FHA receives cash inflows from borrowers' insurance premiums and net proceeds from recoveries on defaulted loans. If the Fund were to be exhausted, the U.S. Treasury would have to cover lenders' claims directly.

Two major trends in the conventional mortgage market have significantly affected FHA.[4] First, in recent years, members of the conventional mortgage market (such as private mortgage insurers, Fannie Mae, and Freddie Mac) increasingly have been active in supporting low- and even no-down-payment mortgages, increasing consumer choices for borrowers who may have previously chosen an FHA-insured loan. Second, to help assess the default risk of borrowers, particularly those with high loan-to-value ratios, the mortgage industry has increasingly used mortgage scoring and automated underwriting systems.[5] Mortgage scoring is a technology-based tool that relies on the statistical analysis of millions of previously originated mortgage loans to determine how key attributes such as the borrower's credit history, property characteristics, and terms of the mortgage affect future loan performance. As a result of such tools, the mortgage industry is able to process loan applications more quickly and

[3]Pursuant to the Federal Credit Reform Act of 1990, HUD must annually estimate the credit subsidy cost for its loan insurance programs. Credit subsidy costs are the net present value of estimated payments it makes less the estimated amounts it receives, excluding administrative costs.

[4]Conventional mortgages do not carry government insurance or guarantees.

[5]Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan.

consistently than in the past. In 2004, FHA implemented a mortgage scoring tool, called the FHA Technology Open to Approved Lenders (TOTAL) Scorecard, to be used in conjunction with existing automated underwriting systems.

HUD's legislative proposal is intended to modernize FHA, in part, to respond to the changes in the mortgage market. The proposal, among other things, would authorize FHA to change the way it sets insurance premiums, insure larger loans, and reduce down-payment requirements. The proposed legislation would enable FHA to depart from its current, essentially flat, premium structure and charge a wider range of premiums based on individual borrowers' risk of default. Currently, FHA also requires homebuyers to make a 3 percent contribution toward the purchase of a property. HUD's proposal would eliminate this contribution requirement and enable FHA to offer some borrowers a no-down-payment product. FHA is subject to limits in the size of the loans it can insure. For example, for a one-family property in a high-cost area, the FHA limit is 87 percent of the limit established by Freddie Mac. The legislative proposal would raise this limit to 100 percent of the Freddie Mac limit.

The Way FHA Developed and Uses TOTAL Limits the Scorecard's Effectiveness in Assessing the Default Risk of Borrowers

If Congress authorizes the reforms HUD has proposed, FHA's ability to assess the default risk of borrowers will take on increased importance because FHA would be adjusting insurance premiums based on its assessments of the credit risk of borrowers and insure potentially larger and riskier mortgages with low or no down payments. A primary tool that FHA uses to assess the default risk of borrowers who apply for FHA-insured mortgages is its TOTAL scorecard.

Age of Data, Lack of Key Variables, and Lack of Policy for Updating TOTAL Could Limit Its Effectiveness

In reports we issued in November 2005 and April 2006, we noted that while FHA's process for developing TOTAL generally was reasonable, some of the choices FHA made in the development process could limit the scorecard's effectiveness.[4] FHA and its contractor used variables that reflected borrower and loan characteristics to create TOTAL, as well as an accepted modeling process to test the variables' accuracy in predicting default. However, we also found that:

- The data used to develop TOTAL were 12 years old by the time FHA implemented the scorecard. Specifically, when FHA began developing TOTAL in 1998, the agency chose to use 1992 loan data, which would be old enough to provide a sufficient number of defaults that could be attributed to a borrower's poor creditworthiness. However, FHA did not implement TOTAL until 2004 and has not subsequently updated the data used in the scorecard. Best practices of private-sector organizations call for scorecards to be based on data that are representative of the current mortgage market—specifically, relevant data that are no more than several years old. In the past 12 years, significant changes—growth in the use of down-payment assistance, for example—have occurred in the mortgage market that have affected the characteristics of those applying for FHA-insured loans. As a result, the relationships between borrower and loan characteristics and the likelihood of default also may have changed.

- TOTAL does not include certain key variables that could help explain expected loan performance. For example, TOTAL does not include a variable for the source of the down payment. However, FHA contractors, HUD's Inspector General, and our work have all identified the source of a down payment as an important indicator of risk, and the use of down-payment assistance in the FHA program has grown rapidly over the last 5 years. Further, TOTAL does not include other important variables—such as a variable for generally riskier adjustable rate loans—included in other scorecards used by private-sector entities.

- Although FHA has a contract to update TOTAL by 2007, the agency did not develop a formal plan for updating TOTAL on a regular basis. Best practices in the private sector and reflected in bank regulator guidance call for having formal policies to ensure that scorecards are routinely

[4] GAO, *Mortgage Financing: HUD Could Realize Additional Benefits from its Mortgage Scorecard*, GAO-06-435 (Washington, D.C.: April 13, 2006). GAO, *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance*, GAO-06-24 (Washington, D.C.: November 9, 2005).

updated. Without policies and procedures for routinely updating TOTAL, the scorecard may become less reliable and, therefore, less effective at predicting the likelihood of default.

To improve TOTAL's effectiveness, we recommended, among other things, that HUD develop policies and procedures for regularly updating TOTAL and more fully consider the risks posed by down-payment assistance when underwriting loans by including the presence and source of down-payment assistance as a loan variable in the scorecard. In response, FHA agreed to consider incorporating a variable for down-payment assistance in TOTAL.

HUD Could Realize Additional Benefits from an Expanded Use of TOTAL

Despite potential limitations in the use of TOTAL, HUD still could realize additional benefits from the scorecard, if, like private-sector lenders and mortgage insurers, it put TOTAL to other uses. Based on its current use of TOTAL, FHA lenders and borrowers have seen two added benefits—less paperwork and more consistent underwriting decisions. However, private lenders and mortgage insurers put their scorecards to other uses, including to help price products based on risk and launch new products. For example, to set risk-based prices, private-sector organizations use scorecards to rank the relative risk of borrowers and price products according to that ranking. By increasing their use of scorecards, these organizations are able to broaden their customer base and improve their financial performance. Adopting these best practices from the private sector could generate similar kinds of benefits for FHA, particularly if FHA were to implement risk-based pricing.

To the extent that conventional mortgage lenders and insurers are better able than FHA to use mortgage scoring to identify and approve relatively low-risk borrowers and charge fees based on default risk, FHA may face adverse selection—that is, conventional providers may approve lower-risk borrowers in FHA's traditional market segment, leaving relatively high-risk borrowers for FHA. Accordingly, the greater the effectiveness of TOTAL, the greater the likelihood that FHA will be able to effectively manage the risks posed by borrowers seeking FHA-insured loans.

To improve how FHA benefits from TOTAL, we recommended that the agency explore additional uses for the scorecard, including using it to implement risk-based pricing of mortgage insurance and to develop new products. These actions could enhance FHA's ability to effectively compete in the mortgage market. In response to our recommendations, FHA indicated that it planned to explore these uses for TOTAL.

FHA's Reestimates Reflect Consistent Underestimation of Program Costs, Primarily Because of Higher Claims than Initially Estimated

If implemented, HUD's legislative proposal could affect the Fund's cash inflows and outflows and, as a result, significantly affect the credit subsidy costs of the insurance program. For example, changes in FHA's insurance premiums could affect the revenues FHA receives, and changes in the composition and riskiness of the loan portfolio (as a result of larger loans or more loans with no down payments) could affect the size and number of insurance claims FHA pays.

As previously noted, FHA, like other federal agencies, is required to reestimate credit subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. FHA has estimated negative credit subsidies for the Fund since 1992, when federal credit reform became effective. However, as we reported in September 2005, with the exception of the 1992 reestimate, FHA's subsidy reestimates have been less favorable than the original estimates.[7] In particular, FHA's $7 billion reestimate for fiscal year 2003 was more than twice the size of any other reestimate from fiscal years 2000 through 2004.

The $7 billion reestimate for fiscal year 2003 had three main components. The first component was the $3.9 billion difference between FHA's fiscal year 2003 estimates of the net present value of future cash flows and the estimates it made one year earlier. Most of this difference stemmed from changes in FHA's estimates of claims and, to a lesser extent, prepayments (the payment of a loan before its maturity date). That is, FHA changed its estimate of future loan performance based on its observation of actual loan performance during fiscal year 2003 and revised economic assumptions. The second component was the $2.1 billion difference between estimated and actual cash flows occurring during fiscal year 2003. Underestimation of claims (net of recoveries on claims) and an overestimation of net fees (insurance premium receipts less premium refunds) for loans made prior to fiscal year 2003 largely account for the difference. The third component was an interest adjustment on the reestimate required by Office of Management and Budget guidance that increased the total reestimate by $1.1 billion.

Several recent policy changes and trends may have contributed to changes in the expected claims underlying the $7 billion reestimate. For example:

[7] GAO, *Mortgage Financing: FHA's $7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates*, GAO-05-875 (Washington, D.C.: Sep. 2, 2005).

- Revised underwriting guidelines made it easier for borrowers who are more susceptible to changes in economic conditions—and therefore more likely to default on their mortgages—to obtain an FHA-insured loan.
- Competition from conventional mortgage providers could have resulted in FHA insuring more risky borrowers.
- FHA insured an increasing number of loans with down-payment assistance, which generally have a greater risk of default.
- FHA's loan performance models did not include key variables that help estimate loan performance, such as credit scores, and as of September 2005, the source of down payment.

The major factors underlying the surge in prepayment activity that also contributed to the reestimate were declining interest rates and rapid appreciation of housing prices. These trends created incentives and opportunities for borrowers to refinance using conventional loans.

To more reliably estimate program costs, we recommended that FHA study and report on how variables found to influence credit risk, such as payment-to-income ratios, credit scores, and down-payment assistance would affect the forecasting ability of its loan performance models. We also recommended that when changing the definitions of key variables, FHA report the impact of such changes on the models' forecasting ability. In response, FHA indicated, among other things, that its contractor was considering the specific variables that we had recommended FHA include in its annual actuarial review and had incorporated the source of down-payment assistance in the 2005 actuarial review of the Fund.

Practices Used by Other Mortgage Institutions Could Help FHA Manage Risks from Low- or No-Down-Payment Products

If Congress authorized FHA to insure mortgages with smaller or no down payments, practices used by other mortgage institutions could help FHA to design and implement these new products. In a February 2005 report, we identified steps that mortgage institutions take when introducing new products.[8] Specifically, mortgage institutions often utilize special requirements when introducing new products, such as requiring additional credit enhancements (mechanisms for transferring risk from one party to another) or implementing stricter underwriting requirements, and limiting how widely they make available a new product.

Mortgage Institutions Require Additional Credit Enhancements, Stricter Underwriting, and Higher Premiums for Low- and No-Down-Payment Products

Some mortgage institutions require additional credit enhancements on low- and no-down-payment products, which generally are riskier because they have higher loan-to-value ratios than loans with larger down payments. For example, Fannie Mae and Freddie Mac mitigate the risk of low- and no-down-payment products by requiring additional credit enhancements such as higher mortgage insurance coverage. Although FHA is required to provide up to 100 percent coverage of the loans it insures, FHA may engage in co-insurance of its single-family loans. Under co-insurance, FHA could require lenders to share in the risks of insuring mortgages by assuming some percentage of the losses on the loans that they originated (lenders would generally use private mortgage insurance for risk sharing).

Mortgage institutions also can mitigate the risk of low- and no-down-payment products through stricter underwriting. Institutions can do this in a number of ways, including requiring a higher credit score threshold for certain products, requiring greater borrower reserves, or requiring more documentation of income or assets from the borrower. Although the changes FHA could make are limited by statutory standards, it could benefit from similar approaches. The HUD Secretary has latitude within statutory limitations to change underwriting requirements for new and existing products and has done so many times. For example, FHA expanded its definition of what could be included as borrower's effective income when calculating payment-to-income ratios. However, FHA officials told us that they were unlikely to mandate a credit score threshold or borrower reserve requirements for a no-down-payment

[8]GAO, *Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products*, GAO-05-194 (Washington, D.C.: Feb. 11, 2005).

product because the product was intended to serve borrowers who are underserved by the conventional market, including those who lack credit scores and have little wealth or personal savings.

Finally, mortgage institutions can increase fees or charge higher premiums to help offset the potential costs of products that are believed to have greater risk. For example, Fannie Mae officials stated that they would charge higher guarantee fees on low- and no-down-payment loans if they were not able to require higher insurance coverage.[9] FHA, if authorized to implement risk-based pricing, could set higher premiums on FHA-insured loans understood to have greater risk.

We recommended that if FHA implemented a no-down-payment mortgage product or other new products about which the risks were not well understood, the agency should (1) consider incorporating stricter underwriting criteria such as appropriate credit score thresholds or borrower reserve requirements and (2) utilize other techniques for mitigating risks, including the use of credit enhancements. In response, FHA said it agreed that these techniques should be evaluated when considering or proposing a new FHA product.

Before Fully Implementing New Products, Some Mortgage Institutions May Limit Availability

Some mortgage institutions initially may offer new products on a limited basis. For example, Fannie Mae and Freddie Mac sometimes use pilots, or limited offerings of new products, to build experience with a new product type. Fannie Mae and Freddie Mac also sometimes set volume limits for the percentage of their business that could be low- and no-down-payment lending. FHA has utilized pilots or demonstrations when making changes to its single-family mortgage insurance but generally has done so in response to legislative requirement rather than on its own initiative. For example, FHA's Home Equity Conversion Mortgage insurance program started as a pilot that authorized FHA to insure 2,500 reverse mortgages.[10] Additionally, some mortgage institutions may limit the origination and servicing of new products to their better lenders and servicers. Fannie Mae and Freddie Mac both reported that these were important steps in introducing a new product.

[9] Fannie Mae and Freddie Mac charge fees for guaranteeing timely payment on mortgage backed securities they issue. The fees are based, in part, on the credit risk they face.

[10] Under this program, homeowners borrow against equity in their home and receive payments from their lenders.

We recommended that when FHA releases new products or makes significant changes to existing products, it consider similar steps to limit the initial availability of these products. FHA officials agreed that they could, under certain circumstances, envision piloting or limiting the ways in which a new product would be available, but pointed to the practical limitations of doing so. For example, FHA officials told us that administering the Home Equity Conversion Mortgage pilot program was difficult because of the challenges of equitably selecting a limited number of lenders and borrowers. FHA generally offers products on a national basis and, if they did not, specific regions of the county or lenders might question why they were not able to receive the same benefit. FHA officials told us they have conducted pilot programs when Congress has authorized them, but they questioned the circumstances under which pilot programs were needed, and also said that they lacked sufficient resources to appropriately manage a pilot. However, if FHA does not limit the availability of new or changed products, the agency runs the risk of facing higher claims from products whose risks may not be well understood.

FHA Has Not Implemented Sufficient Standards and Controls to Manage Risks Associated with the Growing Proportion of Loans with Down-Payment Assistance

HUD's legislative proposal would represent a significant change to the agency's single-family mortgage insurance program and presents new risk management challenges. In our November 2005 report examining FHA's actions to manage the new risks associated with the growing proportion of loans with down-payment assistance, we found that the agency did not implement sufficient standards and controls to manage the risks posed by these loans.[11]

[11] GAO-06-24.

The Percentage of Loans with Down-Payment Assistance in FHA's Portfolio Has Been Increasing and These Loans Do Not Perform as Well as Similar Loans without Assistance

Homebuyers who receive FHA-insured mortgages often have limited funds and, to meet the 3 percent borrower investment FHA currently requires, may obtain down-payment assistance from a third party, such as a relative or a charitable organization (nonprofit) that is funded by property sellers. The proportion of FHA-insured loans that are financed in part by down-payment assistance from various sources has increased substantially in the last few years, while the overall number of loans that FHA insures has fallen dramatically. Money from nonprofits funded by seller contributions has accounted for a growing percentage of that assistance. From 2000 to 2004, the total proportion of FHA-insured purchase loans that had a loan-to-value ratio greater than 95 percent and that also involved down-payment assistance, from any source, grew from 35 to nearly 50 percent. Approximately 6 percent of FHA-insured purchase loans in 2000 received down-payment assistance from nonprofits (the large majority of which were funded by property sellers), but by 2004 nonprofit assistance grew to about 30 percent.

We and others have found that loans with down-payment assistance do not perform as well as loans without down-payment assistance. We analyzed loan performance by source of down-payment assistance, using two samples of FHA-insured purchase loans from 2000, 2001, and 2002—a national sample and a sample from three Metropolitan Statistical Areas (MSA) with high rates of down-payment assistance.[12] Holding other variables constant, our analysis indicated that FHA-insured loans with down-payment assistance had higher delinquency and claim rates than similar loans without such assistance. For example, we found that the probability that loans with nonseller-funded sources of down-payment assistance would result in insurance claims was 49 percent higher in the national sample and 45 percent higher in the MSA sample than it was for comparable loans without assistance. Similarly, the probability that loans with nonprofit seller-funded, down-payment assistance would result in insurance claims was 76 percent higher in the national sample and 166 percent higher in the MSA sample than it was for comparable loans without assistance. The poorer performance of loans with nonprofit seller-funded, down-payment assistance may be explained, in part, by the sales prices of the homes bought with such assistance. More specifically, our analysis indicated that FHA-insured homes bought with seller-funded

[12]The data (current as of June 30, 2005) consisted of purchase loans insured by FHA's 203(b) program, its main single-family program, and its 234(c), condominium program. The three MSAs were Atlanta, Indianapolis, and Salt Lake City.

nonprofit assistance were appraised and sold for about 2 to 3 percent more than comparable homes bought without such assistance. The difference in performance also may be partially explained by the homebuyer having less equity in the transaction.

Stricter Standards and Additional Controls Could Help FHA Manage the Risks Posed by Loans with Down-Payment Assistance

FHA has implemented some standards and internal controls to manage the risks associated with loans with down-payment assistance, but stricter standards and additional controls could help FHA better manage risks posed by these loans while meeting its mission of expanding homeownership opportunities. Like other mortgage industry participants, FHA generally applies the same underwriting standards to loans with down-payment assistance that it applies to loans without such assistance. One important exception is that FHA, unlike others, does not limit the use of down-payment assistance from seller-funded nonprofits. Some mortgage industry participants view assistance from seller-funded nonprofits as a seller inducement to the sale and, therefore, either restrict or prohibit its use. FHA has not viewed such assistance as a seller inducement and, therefore, does not subject this assistance to the limits it otherwise places on contributions from sellers. However, due in part to concerns about loans with nonprofit seller-funded, down-payment assistance, FHA has proposed legislation that could help eliminate the need for such assistance by allowing some FHA borrowers to make no down payments for an FHA-insured loan.

FHA has taken some steps to assess and manage the risks associated with loans with down-payment assistance, but additional controls may be warranted. For example, FHA has contracted for two studies to assess the use of such assistance with FHA-insured loans and conducted ad hoc performance analyses of loans with down-payment assistance but has not routinely assessed the impact that the widespread use of down-payment assistance has had on loan performance. Also, FHA has targeted its monitoring of appraisers to those that do a high volume of loans with down-payment assistance, but FHA has not targeted its monitoring of lenders to those that do a high volume of loans with down-payment assistance, even though FHA holds lenders, as well as appraisers, accountable for ensuring a fair valuation of the property it insures.

Our report made several recommendations designed to better manage the risks of loans with down-payment assistance generally, and more specifically from seller-funded nonprofits. Overall, we recommended that in considering the costs and benefits of its policy permitting down-payment assistance, FHA also consider risk-mitigation techniques such as

including down-payment assistance as a factor when underwriting loans or more closely monitoring loans with such assistance. For down-payment assistance providers that receive funding from property sellers, we recommended that FHA take additional steps to mitigate the risks of these loans, such as treating such assistance as a seller contribution and, therefore, subject to existing limits on seller contributions. In response, FHA agreed to improve its oversight of down-payment assistance lending by (1) modifying its information systems to document assistance from seller-funded nonprofits and (2) requiring lenders to inform appraisers when assistance is provided by seller-funded nonprofits. In addition, HUD has proposed a zero down-payment program as an alternative to seller-funded, down-payment assistance.

In May 2006, the Internal Revenue Service issued a ruling stating that organizations that provide seller-funded, down-payment assistance to home buyers do not qualify as tax-exempt charities. FHA permitted these organizations to provide down-payment assistance because they qualified as charities. Accordingly, the ruling could significantly reduce the number of FHA-insured loans with seller-funded down payments.

Observations

The risks FHA faces in today's mortgage market are growing. For example, the agency has seen increased competition from conventional mortgage and insurance providers, many of which offer low- and no-down-payment products and that may be better able than FHA to identify and approve relatively low-risk borrowers. Additionally, FHA is insuring a greater proportion of loans with down-payment assistance. These loans are more likely to result in insurance claims than loans without such assistance.

To effectively manage the risks posed by FHA's existing products, we have concluded from our prior work that the agency must significantly improve its risk management and cost estimation practices. We are encouraged by a variety of steps FHA has taken to enhance its capabilities in these areas, such as developing and implementing a mortgage scorecard and improving its loan performance models. However, FHA needs to take additional steps, such as establishing policies and procedures for updating TOTAL scorecard on a regular basis, more fully considering the risks posed by down-payment assistance when underwriting loans, developing a framework for introducing new products in a way that mitigates risk, and studying and reporting on the impact of variables found to influence credit risk that are not currently in the agency's loan performance models.

HUD's legislative proposal could help FHA serve more low-income and first-time homebuyers, but also would introduce additional risks to the Fund. Consideration of this proposal should include serious deliberation of the associated risks and the capacity of FHA to mitigate them.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgments

For further information on this testimony, please contact William B. Shear at (202) 512-8678. Individuals making key contributions to this testimony included Triana Bash, Anne Cangi, Marcia Carlsen, John Fisher, Austin Kelly, John McGrail, Andrew Pauline, Barbara Roesmann, Mathew Scirè, Katherine Trimble, and Steve Westley.

PREPARED STATEMENT OF REGINA M. LOWRIE

CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

JUNE 20, 2006

Thank you for holding this hearing and inviting the Mortgage Bankers Association (MBA)[1] to share its views with the Subcommittee on "FHA: Issues for the Future." My name is Regina M. Lowrie and I am the President of Gateway Funding Diversified Mortgage Services, LP in Horsham, Pennsylvania and Chairman of the Mortgage Bankers Association. I am here today because MBA believes that the Senate must act to make important legislative changes to the National Housing Act if the Federal Housing Administration (FHA) is to continue to be a financially sound tool for lenders to use in serving the housing needs of American families who are unserved or underserved by conventional markets.

In 1994, I founded Gateway with only seven employees and $1.5 million in startup capital. Over the past 12 years, I have grown the company to over 800 employees working in more than 58 offices, originating $3 billion in loans annually throughout Pennsylvania, Delaware, New Jersey, and Maryland. I am proud of the work of Gateway, and of the mortgage industry itself, in providing opportunities for home ownership for families of this great land.

When I started Gateway, the programs of FHA were invaluable in enabling us to serve families who otherwise would have no other affordable alternative for financing their home. Ten years ago, FHA loans comprised 40 percent of Gateway's volume. We worked hard to be a good partner with FHA in administering its programs and, together, FHA and Gateway enabled tens of thousands of families to purchase their first homes.

Today, though, the story is very different. While Gateway has grown significantly, our ability to use the FHA program has declined precipitously. Gateway has been able to adapt to changes in the mortgage markets, but FHA has been prevented from doing so. The needs of low- and moderate-income home buyers, of first-time home buyers, of minority home buyers, and of senior homeowners have changed. FHA's programs though, have not followed their historic path of adaptation to meet these borrowers' changing needs.

The numbers are troublesome. In 1990, 13 percent of total originations in the United States were FHA-insured mortgages. In 2004, that number dropped to near 3.5 percent. More importantly, in 1990, 28 percent of new home sales (which are typically a large first-time home buyer market) were financed through programs at FHA or the Department of Veterans Affairs (VA); today that number has dropped to under 12 percent.

MBA cites these numbers not because we believe that there is a certain market share that FHA should retain, but rather because these numbers are consistent with many lenders' views that FHA has not kept up with changes in the market. These numbers point to a decline, not just in marketshare, but in FHA's potential to positively impact home ownership. This loss of impact does not stem from the fact that FHA is no longer relevant, but rather that statutory constraints prohibit FHA from adapting its relevance to consumer needs today.

A recent anecdote illustrates this point very well. A story ran in RealtyTimes® 1 year ago, on June 21, 2005, in which a Baltimore, MD, real estate agent unabashedly advises home buyers to avoid FHA financing. The agent states: "Approved FHA loan recipients, same notice to you, don't bother bringing it to the table during a sellers market. More times than not, your offer will be rejected. We know that VA and FHA loans allow you the means of purchasing more home for the mortgage, but it only works if you are the only game in town." His advice was based on the often true notion that FHA-insured financing is slower and more laborious than conventional financing.

This is a very unfortunate perspective, especially because FHA is vitally needed today. Thus, MBA is not focused on FHA marketshare in and of itself, but rather

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand home ownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's web site: *http://www.mortgagebankers.org.*

because it signals whether or not FHA's valuable programs are reaching the people they should.

MBA is committed to supporting FHA. Nowhere in Washington will you find a stronger supporter of the FHA and the programs it offers. Mortgage lenders are the private delivery system that allows FHA to reach borrowers with affordable home ownership financing and rental housing opportunities, especially low- and moderate-income families, first-time home buyers, minorities, and the elderly. Every day, mortgage lenders sit down with the very families FHA seeks to serve to discuss how we can help them realize their dreams. Maybe we understand better than most that without FHA, many American families simply would not have had and will not have the opportunity to own their own home.

FHA Background

FHA was created as an independent entity by the National Housing Act on June 27, 1934 to encourage improvement in housing standards and conditions, to provide an adequate home-financing system by insurance of housing mortgages and credit, and to exert a stabilizing influence on the mortgage market. FHA was incorporated into the newly formed U.S. Department of Housing and Urban Development (HUD) in 1965. Over the years, FHA has facilitated the availability of capital for the nation's multifamily and single-family housing market by providing government-insured financing on a loan-by-loan basis.

FHA offers multifamily and single-family insurance programs that work through private lenders to extend financing for homes. FHA has historically been an innovator. Over the past several decades, the mission of FHA's single-family programs have increasingly focused on expanding home ownership for those families who would otherwise either be unable to obtain financing or obtain financing with affordable terms. FHA's multifamily programs have allowed projects to be developed in areas that otherwise would be difficult to finance and provides needed rental housing to families that might otherwise be priced out of a community.

Additionally, the FHA program has been a stabilizing influence on the nation's housing markets due to the fact that it is consistently available under the same terms at all times and in all places. FHA does not withdraw from markets.

FHA Single-family Programs

Single-family FHA-insured mortgages are made by private lenders, such as mortgage companies, banks, and thrifts. FHA insures single-family mortgages with more flexible underwriting requirements than might otherwise be available. Approved FHA mortgage lenders process, underwrite and close FHA-insured mortgages without prior FHA approval. As an incentive to reach into harder to serve populations, FHA insures 100 percent of the loan balance as long as the loan is properly underwritten.

FHA has a strong history of innovating mortgage products to serve an increasing number of home buyers. FHA was the first nationwide mortgage program; the first to offer 20-year, 25-year, and finally 30-year amortizing mortgages; and the first to lower downpayment requirements from 20 percent to 10 percent to 5 percent to 3 percent. FHA has always performed a market stabilizing function by ensuring that mortgage lending continued after local economic collapses or regional natural disasters when many other lenders and mortgage insurers pulled out of these markets.

FHA's primary single-family program is funded through the Mutual Mortgage Insurance Fund (MMIF), which operates similar to a trust fund and has been completely self-sufficient. This allows FHA to accomplish its mission at little or no cost to the government. In fact, FHA's operations transfer funds to the U.S. Treasury each year, thereby reducing the Federal deficit. FHA has always accomplished its mission without cost to the taxpayer. At no time in FHA's history has the U.S. Treasury ever had to "bail out" the MMIF or the FHA.

FHA Multifamily Programs

While much focus over the past several months has been on FHA's single-family programs, it is important to underscore the critical role of FHA's multifamily programs in providing decent, affordable rental housing to many Americans. There are a number of families and elderly citizens who either prefer to rent or who cannot afford to own their own homes. FHA's insurance of multifamily mortgages provides a cost-effective means of generating new construction or rehabilitation of rental housing across the nation. As well, FHA is one of the primary generators of capital for healthcare facilities, particularly nursing homes.

While the FHA has implemented a number of significant improvements to its single-family program over the last year, the same focus needs to be applied to improving the multifamily programs. MBA hopes that process improvements on the multifamily side of FHA will soon be discussed and implemented.

The Need for FHA Today and Tomorrow

The FHA single-family programs are vital to many home buyers who desire to own a home but cannot find affordable financing to realize this dream. While the FHA has had a number of roles throughout its history, its most important role today is to give first-time home buyers the ability to climb onto the first rung of the home ownership ladder and to act as a vehicle for closing the home ownership gap for minorities and low- and moderate-income families.

Despite this country's recent record high levels of home ownership, not all families share in this dream equally. As of the first quarter of 2006, the national home ownership rate stood at 68.5 percent, but only 51 percent of minorities owned their own home. Only 48 percent of African-Americans and 49.4 percent of Latinos owned their own homes. This compares with 75.5 percent of non-Hispanic white households.

By the end of 2005, 84.3 percent of families earning more than the median income owned their own home, while only 53.1 percent of families below the median income owned their own home.

These discrepancies are tragic because home ownership remains the most important wealth-building tool the average American family has.

FHA's Record

More than any other nationally available program, during the 1990s, FHA's impact focused on the needs of first-time, minority, and/or low- and moderate-income borrowers.

In 1990, 64 percent of FHA borrowers using FHA to purchase a home were first-time home buyers. Today, that rate has climbed to about 80 percent. In 1992, about one in five FHA-insured purchase loans went to minority home buyers. That number in recent years has grown to more than one in three. Minorities make up a greater percentage of FHA borrowers than they do conventional market borrowers.

FHA is particularly important to those minority populations experiencing the largest home ownership gaps. Home Mortgage Disclosure Act (HMDA) data reveal that in 2004, 14.2 percent of FHA borrowers were African-Americans, compared with 5.4 percent of conventional borrowers. Hispanic borrowers made up 15.3 percent of FHA loans, while they were only 8.9 percent of the conventional market. Combined, African-American and Hispanic borrowers constituted 29.5 percent of FHA loans, doubling the conventional market's rate of 14.3 percent. In fact, in 2004, FHA insured nearly as many purchase loans to African-American and Hispanic families as were purchased by Fannie Mae and Freddie Mac combined.

The same data demonstrates FHA's tremendous service to those American families earning near or below the national median income. Over 57 percent of FHA borrowers earned less than $50,000, which is more than double the rate of the conventional market, where fewer than 28 percent of borrowers earned less than $50,000.

Ironically, as the above numbers reveal, FHA's mission to serve underserved populations has become increasingly focused during the same period as the decline in FHA's presence in the market. FHA's impact is being lost at the very time when it is needed most. The result is that American families are either turning to more expensive financing or giving up.

It is crucial that FHA keep pace with changes in the U.S. mortgage markets. While FHA programs can be the best and most cost-effective way of expanding lending to underserved communities, we have yet to unleash the full potential of these programs to help this country achieve important societal goals.

To be effective in the 21st century, FHA should be empowered to incorporate private sector efficiencies that allow it to develop products and programs to meet the needs of today's home buyers and anticipate the needs of tomorrow's mortgage markets, while at the same time being fully accountable for the results it achieves and the impact of its programs.

Under the strong leadership of its current Commissioner, Brian Montgomery, FHA has undertaken significant changes to its regulations and operations in a very short time. In just 1 year, FHA has streamlined the insurance endorsement process, improved appraisal requirements, and removed some unnecessary regulations. By doing so, Commissioner Montgomery has also instilled a spirit of change and a bias for action within FHA.

MBA compliments the Commissioner on his significant accomplishments to date, though we recognize that more work lies ahead. Lenders still report that FHA is difficult to work with and that oversight activities often focus on minor compliance deficiencies in a loan file rather than focusing on issues of true risk to FHA's insurance funds. FHA is designed to serve higher-risk borrowers and MBA believes that those auditing FHA lenders must understand this and be able to differentiate this aspect of the program from intentional abuse.

MBA is confident in the Commissioner's ability to address these and other issues that are within his control. There is much though, that is beyond FHA's control and needs Congressional action.

FHA Reform is Urgent

MBA is concerned that while FHA is currently sound and under the strong leadership of Commissioner Montgomery, without imbuing FHA with the flexibility to adapt to 21st century mortgage markets, the health of FHA operations will be at risk in the future. While the annual audit of the MMIF has consistently found over the past 10 years that the fund is operating soundly and well in excess of capital ratios established by Congress, there have also been signs that statutory constraints are causing FHA to be adversely selected.

Unleashing FHA's Potential

In reviewing the status of FHA over the past decade, MBA has come to the conclusion that FHA faces severe challenges in managing its resources and programs in a quickly changing mortgage market. These challenges have already diminished FHA's ability to serve its public purposes and have also made it susceptible to fraud, waste, and abuse. Unaddressed, these issues will cause FHA to become less relevant, and will leave families served by its programs with no alternative for home ownership or affordable rental housing.

In the Fall of 2004, MBA formed a *FHA Empowerment Task Force* comprising of MBA member companies experienced in originating single-family and multifamily FHA loans. The Task Force discussed the long-term issues confronting FHA with the goal of developing legislative proposals that would empower it to manage its programs and policies more effectively.

The Task Force identified FHA's higher costs of originations, lessening prominence in the market, out-dated technology, adverse selection, and the inability to efficiently develop products as problems for FHA. Per the Task Force's recommendations, MBA proposed the following three steps to unleash FHA from overly burdensome statutory processes and restrictions, and to empower FHA to adopt important private sector efficiencies:

1. FHA needs the ability to use a portion of the revenues generated by its operations to invest in the upgrade and maintenance of technology to adequately manage its portfolios and interface with lenders.
2. FHA needs greater flexibility to recruit, manage, and compensate employees if it is to keep pace with a changing financial landscape and ensure appropriate staffing to the task of managing $450+ billion insurance funds.
3. FHA needs greater autonomy to make changes to their programs and to develop new products that will better serve those who are not being adequately served by others in the mortgage market.

Ability To Invest Revenues in Technology

Technology's impact on U.S. mortgage markets over the past 15 years cannot be overstated. Technology has allowed the mortgage industry to lower the cost of home ownership, streamline the origination process, and has allowed more borrowers to qualify for financing. The creation of automated underwriting systems, sophisticated credit-score modeling, and business-to-business electronic commerce are but a few examples of technology's impact.

FHA has been detrimentally slow to move from a paper-based process and it cannot electronically interface with its business customers in the same manner as the private sector. During 2004 and 2005, over 1.5 million paper loan files were mailed back and forth between FHA and its approved lenders and manually reviewed during the endorsement process. Despite the fact that FHA published regulations in 1997 authorizing electronic endorsement of loans, FHA was not able to implement this regulation until this past January, 8 years after the fact. This delay occurred despite the fact that over the same 8 years, FHA's operations generated billions of dollars in excess of program costs that was transferred to the U.S. Treasury.

MBA believes FHA cannot create and implement technological improvements because it lacks sufficient authority to use the revenues it generates to invest in technology.

MBA proposes the creation of a separate fund specifically for FHA technology, funded by revenues generated by the operation of the MMIF. MBA suggests the establishment of a revenue and a capital ratio benchmark for FHA, wherein, if both are exceeded, FHA be authorized by Congress to use a portion of the excess revenue generated to invest in its technology. Such a mechanism would allow FHA to invest in technology upgrades, without requiring additional appropriations from Congress.

Improvements to FHA's technology will allow it to improve management of its portfolio, garner efficiencies, and lower operational costs, which will allow it to reach

farther down the risk spectrum to borrowers currently unable to achieve home ownership. MBA believes that such an investment would yield cost-savings to FHA operations far in excess of the dollar investment amount.

Greater Control in Managing Human Resources

FHA is restricted in its ability to effectively manage its human resources at a time when the sophistication of the U.S. mortgage markets demand market participants to be experienced, knowledgeable, flexible, and innovative. To fulfill its mission, FHA needs to be able to attract the best and brightest. Other Federal agencies, such as the Federal Deposit Insurance Corporation (FDIC), that interface with and oversee the financial services sector are given greater authority to manage and incentivize their human resources. MBA believes that FHA should have similar authority if it is to remain relevant in providing home ownership opportunities to those families underserved by the private markets.

FHA should have more flexibility in its personnel structure than that which is provided under the regular Federal civil service rules. With greater freedom, FHA could operate more efficiently and effectively at a lower cost. Further, improvements to FHA's ability to manage its human capital will allow FHA to attract and manage the talent necessary to develop and implement the strategies that will provide opportunities for home ownership to underserved segments of the market.

Flexibility To Create Products and Make Program Changes

FHA programs are slow to adapt to changing needs within the mortgage markets. Whether it is small technical issues or larger program needs, it often takes many years and the expenditure of great resources to implement changes. This process overly burdens FHA from efficiently making changes that will serve home buyers and renters better and protect FHA's insurance funds.

Today's mortgage markets require agencies that are empowered to implement changes quickly and to roll-out or test new programs to address underserved segments of the market.

A prime example of this problem can be found in the recent experience of FHA in offering hybrid Adjustable-Rate Mortgage (ARM) products. A hybrid ARM is a mortgage product which offers borrowers a fixed-interest rate for a specified period of time, after which the rate adjusts periodically at a certain margin over an agreed upon index. Lenders are typically able to offer a lower initial interest rate on a 30-year hybrid ARM than on a 30-year fixed-rate mortgage. During the late 1990s, hybrid ARMs grew in popularity in the conventional market due to the fact that they offer borrowers a compromise between the lower rates associated with ARM products and the benefits of a fixed-rate period.

In order for FHA to offer this product to the home buyers it serves, legislative approval was required. After several years of advocacy efforts, such approval was granted with the passage of Public Law 107–73 in November 2001. Unfortunately, this authority was not fully implemented until the Spring of 2005.

The problem began when Public Law 107–73 included an interest-rate cap structure for the 5/1 hybrid ARMs that was not viable in the marketplace. The 5/1 hybrid ARM has been the most popular hybrid ARM in the conventional market. As FHA began the rulemaking process for implementing the new program, they had no choice but to issue a proposed rule for comment with a 5/1 cap structure as dictated in legislation. By the time MBA submitted its comment letter on the proposed rule to FHA, we had already supported efforts within Congress to have legislation introduced that would amend the statute to change the cap structure. MBA's comments urged that, if passed prior to final rulemaking, the 5/1 cap fix be included in the final rule.

On December 16, 2003, Public Law 108–186 was signed into law amending the hybrid ARM statutes to make the required technical fix to the interest rate cap structure affecting the 5/1 hybrid ARM product. At this point, FHA was ready to publish a final rule. Regardless of the passage of Public Law 108–186, FHA was forced to go through additional rulemaking in order to incorporate the fix into regulation. Thus on March 10, 2004, FHA issued a Final Rule authorizing the hybrid ARM program, with a cap structure that made FHA's 5/1 hybrid ARM unworkable in the marketplace. It was not until March 29, 2005 that FHA was able to complete rulemaking on the amendment and implement the new cap structure for the 5/1 hybrid ARM product.

The hybrid ARM story demonstrates well the statutory straitjacket under which the FHA operates. A 4 to 6 year lag in introducing program changes is simply unacceptable in today's market. Each year that a new program is delayed or a rule is held-up, means that families who could otherwise be served by the program are prevented from realizing the dream of home ownership or securing affordable rental

housing. MBA believes the above three changes will allow FHA to become an organization that can effectively manage risk and self-adapt to shifting mortgage market conditions while meeting the housing needs of those families who continue to be unserved or underserved today.

Legislative Activity

MBA is supportive of much of the legislation that is currently before Congress, and I would like to take a moment to offer our perspective on various provisions.

On April 4, 2005, Representatives Bob Ney and Maxine Waters introduced the *Expanding American Home Ownership Act of 2006,* H.R. 5121. This bi-partisan bill, which has over 67 co-sponsors, marks the first time FHA is being looked at by Congress in a comprehensive way in over 10 years.

In general, H.R. 5121 significantly streamlines and modernizes the National Housing Act and seeks to unleash FHA from a 74 year-old statutory regime that constricts its effectiveness. Among other things, H.R. 5121 would provide for flexible downpayments, flexible risk-based premiums, an increase in mortgage limits, an extension of mortgage terms, reform of FHA's condominium program, and changes to the Home Equity Conversion Mortgage (HECM) program.

MBA would note that the Congressional Budget Office (CBO) has recently reported that H.R. 5121 would generate $247 million in revenues for the U.S. Treasury in 2007 and $2.3 billion in revenues during fiscal years 2007–2011. This report makes it obvious that the reforms proposed in H.R. 5121 are not only beneficial to FHA and to the home buyers it serves, but it is beneficial to the U.S. government's bottom line.

More importantly to this Subcommittee is legislation that has been discussed or introduced in the Senate. Currently, MBA is aware of three bills that affect FHA that have been introduced and one that may be introduced. MBA would like to briefly comment on each one.

MBA would like to review a number of provisions that we understand may be part of legislation introduced in the Senate as a companion bill to H.R. 5121.

Downpayment Requirements

MBA supports the elimination of the complicated formula for determining the downpayment that is currently detailed in the statute. The calculation is outdated and unnecessarily complex. The calculation of the downpayment alone is often cited by loan officers as a reason for not offering the FHA product. MBA supports the elimination of the statutory requirement that the borrower provide a minimum cash investment. Improving FHA's products with such downpayment flexibility is one of the most important innovations FHA can be empowered to make. Independent studies have demonstrated two important facts: first, the downpayment is one of the primary obstacles for first-time home buyers, minorities, and low- and moderate-income home buyers. Second, the downpayment itself, in many cases, is not as important a factor in determining risk as are other factors.

The private market has already demonstrated that the downpayment can be replaced with other risk-mitigating features without significantly hurting performance. Many borrowers will be in a better financial position if they keep the funds they would have expended for the downpayment as a cash reserve for unexpected home ownership costs or life events.

We believe that FHA should be empowered to establish policies that would allow borrowers to qualify for FHA insurance with flexible downpayment requirements and decide the amount of the cash investment they would like to make in purchasing a home.

Adjusting Mortgage Insurance Premiums for Loan Level Risk

MBA believes that FHA would be able to serve more borrowers, and do so with lower risk to the MMIF, if they are able to adjust premiums based on the risk of each mortgage they insure. A flexible premium structure could also give borrowers greater choice in how they utilize the FHA program.

It is a fact that some borrowers and loans will pose a greater risk to FHA than others. At some level, FHA should have the authority to adjust premiums based upon some borrower or loan factors that add risk. Such adjustment for risk need not be a complicated formula. MBA believes FHA could significantly mitigate the risk to the MMIF by selecting a small number of risk factors that would cause an adjustment from a base mortgage insurance premium (MIP).

A current example of this would be the fact that borrowers receiving a gift of the downpayment on a FHA-insured mortgage is charged the same premium as a borrower who puts down 3 percent of their own funds, despite the fact that the former represents a higher risk loan. FHA could better address such a risk in the MMIF by charging a higher MIP to offset some of the additional risk that such a borrower

poses. In this manner, while a borrower receiving a gift of funds for the downpayment will still receive the benefits of FHA financing, they themselves would share some of the risk, rather than having the risk born solely by those making a 3 percent downpayment.

Creating a risk-based premium structure will only be beneficial to consumers, though, if FHA considers lowering of current premiums to less risky loans. We would not support simply raising current premiums for higher-risk borrowers.

In December 2004, FHA eliminated the practice of refunding the unearned portion of the Up-front Mortgage Insurance Premium (UfMIP) to borrowers who prepay their FHA-insured mortgage early and go to another product. MBA was hopeful that the removal of the refund (which admittedly was an administrative cost for FHA and servicers) would have been followed by a correlated lowering of the UfMIP. This did not happen. The net effect was to actually raise the cost of the FHA program. MBA would not want to see the same thing happen under a risk-based premium structure.

Raising Maximum Mortgage Limits for High-Cost Areas

MBA supports the proposal to raise FHA's maximum mortgage limits to 100 percent of an area's median home price (currently pegged at 95 percent) and to raise the ceiling to 100 percent of the conforming loan limit (currently limited to 87 percent) and the floor to 65 percent (currently 48 percent).

There is a strong need for FHA financing to be relevant in areas with high home prices. MBA believes raising the limits to conforming limits in these areas strikes a good balance between allowing FHA to serve a greater number of borrowers without taking on additional risk. The CBO scored this provision in H.R. 5121 as a net revenue generator for the Treasury, indicating that it will improve FHA's performance.

Additionally, in many low-cost areas, FHA's loan limits are not sufficient to cover the costs of new construction. New construction targeted to first-time home buyers has historically been a part of the market in which FHA has had a large presence. MBA believes raising the floor will improve the ability of first-time home buyers to purchase modest newly constructed homes in low-cost areas since they will be able to use FHA-insured financing.

Lengthening Mortgage Term

MBA supports authorizing FHA to develop products with mortgage terms up to 40 years. Currently, FHA is generally limited to products with terms of no more than 30 years. Stretching out the term will lower the monthly mortgage payment and allow more borrowers to qualify for a loan while remaining in a product that continues to amortize. We believe FHA should have the ability to test products with these features, and then, based on performance and home buyer needs, to improve or remove such a product.

Improvements to FHA Condominium Financing

MBA supports changes to FHA's condominium program that will streamline the process for obtaining project approval and allow for greater use of this program. It is unfortunate to note that FHA insurance on condominium units has dropped at a higher rate than the overall decline in FHA's originations. This decline contradicts the fact that in costly markets, condominium units are typically the primary type of housing for first-time home buyers. FHA should have a much bigger presence in the condominium market.

Improvements to the Reverse Mortgage Program

MBA unequivocally supports all of the following proposed changes to FHA's Home Equity Conversion Mortgage (HECM) program: the removal of the current 250,000 loan cap, the authorization of HECMs for home purchase and on properties less than 1-year old, and the creation of a single, national loan limit for the HECM program.

The HECM program has proven itself to be an important financing product for this country's senior homeowners, allowing them to access the equity in their homes without having to worry about making mortgage payments until they move out. The program has allowed tens of thousands of senior homeowners to pay for items that have given them greater freedom, such as improvements to their homes that have allowed them to age in place, or to meet monthly living expenses without having to move out of the family home.

MBA believes it is time to remove the program's cap because the cap threatens to limit the HECM program at a time when more and more seniors are turning to reverse mortgages as a means to provide necessary funds for their daily lives. MBA further believes that the HECM program has earned the right to be on par with

other FHA programs that are subject only to FHA's overall insurance fund caps. Additionally, removing the program cap will serve to lower costs as more lenders will be encouraged to enter the reverse mortgage market.

Additionally, authorizing the HECM program for home purchase will improve housing options for seniors. In a HECM for purchase transaction, a senior homeowner might sell a property they own to move to be near family. The proceeds of the sale could be combined with a reverse mortgage, originated at closing and paid in a lump sum, to allow a senior to purchase the home without the future responsibility of monthly mortgage payments. Alternatively, a senior homeowner may wish to take out a reverse mortgage on a property that is less than 1-year old, defined as "new construction" by FHA.

Finally, the HECM program should have a single, national loan limit equal to the conforming loan limit. Currently, the HECM program is subject to the same county-by-county loan limits as FHA's forward programs. HECM borrowers are disadvantaged under this system because they are not able to access the full value of the equity they have built up over the years by making their mortgage payments. A senior homeowner living in a high-cost area will be able to access more equity than a senior living in a lower-cost area, despite the fact that their homes may be worth the same and they have the same amount of equity built up. Reverse mortgages are different than forward mortgages and the reasons for loan limits are different, too. FHA needs the flexibility to implement different policies, especially concerning loan limits.

In addition to the above proposed legislation, MBA is aware of three pieces of legislation which have been introduced in the Senate that would positively affect FHA. These are S. 2123 the "FHA Manufactured Housing Loan Modernization Act of 2005," S. 2597 "The Federal Housing Fairness Act of 2006," and S. 3173 the "21st Century Housing Act." MBA would like to highlight each of these bills.

The FHA Manufactured Housing Loan Modernization Act of 2005—S. 2123

On December 16, 2005, Senator Allard (R–CO) introduced S. 2123, the *FHA Manufactured Housing Loan Modernization Act of 2005.* The proposals outlined in S. 2123 would help make FHA a leader in promoting sound financing of manufactured housing. MBA understands that the provisions of S. 2123 will be included in the proposed Senate companion legislation to H.R. 5121.

MBA supports revitalizing FHA's Title I manufactured housing mortgage insurance program. Manufactured housing is an important source of affordable housing but FHA's current program to insure mortgages of manufactured housing needs to be updated in order to be relevant to this market.

The Federal Housing Fairness Act of 2006—S. 2597

On April 7, 2006, Senator Hillary Clinton (D–NY) introduced S. 2597 "The Federal Housing Fairness Act of 2006." MBA strongly supports S. 2597, which would facilitate home ownership in high-cost areas.

The sole provision of this bill would amend the National Housing Act by raising FHA loan limits to 100 percent of an area's median home price, not to exceed the conforming loan limit. Currently, FHA loan limits are set at 95 percent of an area's median home price not to exceed 87 percent of the conforming loan limit.

21st Century Housing Act—S. 3173

On May 25, 2006, Senator Clinton introduced S. 3173, the "21st Century Housing Act." MBA supports S. 3173 which has a number of provisions that would significantly modernize FHA and its programs. The bill contains the following positive provisions:

Investment in FHA Infrastructure—Human Resources

MBA supports authorizing the Secretary of HUD to appoint and fix the compensation of FHA employees and officers. The bill calls on the Secretary to consult with, and maintain comparability with, the compensation of officers and employees of the Federal Deposit Insurance Corporation. This provision can be carried out by excess revenue derived from the operation of FHA's insurance funds, beyond that which was estimated in the Federal budget for any given year.

While MBA has some questions as to the funding mechanism detailed in the bill for this provision, we firmly believe that giving FHA greater flexibility in investing in its human capital is critical if it is to attract and retain the talent it needs to become a stronger and more effective program serving the needs of our nation's homeowners and renters.

Investment in FHA Infrastructure—Information Technology

MBA strongly supports this provision of S. 3173, which would fund investment in FHA's information technology. This provision contemplates that excess funding derived from the operation of FHA's insurance funds, beyond that which was estimated in the Federal budget for any given year, would be used to carry out this provision.

While MBA has some questions as to the funding mechanism detailed in the bill for this provision MBA believes that upgrading FHA's technology is critical to improving FHA's management of its portfolio and lowering its operational costs. MBA also believes that such an investment will allow FHA to reach farther down the risk spectrum to borrowers currently unable to achieve home ownership.

Extension of Mortgage Term Authority

MBA supports an extension of FHA's mortgage term authority. S. 3173 would amend the National Housing Act by extending FHA's mortgage term authority to 50 years. MBA believes this flexibility would allow FHA to develop products that lower monthly costs and make home ownership a more viable option for many families.

Downpayment Flexibility

Since the downpayment is one of the primary obstacles for first-time home buyers, minorities, and low- and moderate-income home buyers, MBA supports this provision that would allow for flexible downpayments. In many cases, the downpayment itself is not as important a factor in determining risk as are other factors, such as credit scores.

MBA believes that a flexible downpayment will allow borrowers to have a cash reserve that may be necessary for the upkeep and maintenance of their homes, as well as for other unforeseen life events.

Mortgage Insurance Flexibility

S. 3173 would allow the Secretary of HUD to establish the cost of a mortgage insurance premium payment, based on factors determined by the Secretary and commensurate with the likelihood of default of the borrower.

MBA supports this provision, as we recognize that FHA may be able to serve more borrowers and do so with lower risk if they are able to adjust premiums based on the risk of each mortgage it insures.

Increasing Maximum Mortgage Limits for Multifamily Housing in High Cost Areas

MBA supports the provision in S. 3173 that would increase loan limits from 140 percent to 170 percent of the basic statutory limits in high-cost areas, and from 170 percent to 215 percent of the basic statutory limits to allow for higher than typical costs for individual projects. MBA recognizes that home ownership is not necessarily appropriate for every American, and it is important that there are affordable rental housing options as well as adequate healthcare facilities in communities.

Multifamily concerns

Additionally, I must voice MBA's strong opposition to the proposal in the Administration's budget to increase the insurance premiums on multifamily projects far above that necessary to operate a financially sound program. The net effect of this proposal will be to cause many affordable rental properties not to be built or rehabilitated and to raise rents on those families and elderly households on the projects that still go through.

There is no rationale for this fee increase except to generate additional revenue for the Federal Government as these programs are already priced to cover their costs. We urge the committee to prohibit FHA from implementing this fee increase.

Conclusion

FHA's presence in the single-family marketplace is smaller than it has been in the past and its impact is diminishing. Many MBA members, who have been traditionally strong FHA lenders, have seen their production of FHA loans drop significantly. This belies the fact that FHA's purposes are still relevant and its potential to help borrowers is still necessary.

I would like to conclude my testimony highlighting two issues which make passing FHA legislation particularly urgent this year.

First, hurricane season is upon us. The disasters of Hurricanes Katrina and Rita point to the need for a financially solvent FHA that is not restricted by onerous processes and procedures. The FHA program must be ready to assist homeowners and renters who lost everything amid the destruction of the hurricanes. It must have the necessary wherewithal to step in and help work out the existing mortgages

in disaster areas. FHA must have the programs necessary to meaningfully assist in the rebuilding effort. Giving FHA the mechanisms to fund adequate technology improvements, flexibilities in managing human resources, and greater authority to introduce products will ensure FHA can step in to help communities when disasters occur.

Second, without Congressional action this year, many families face a serious risk of being unable to access FHA financing due to a recent ruling passed down by the Internal Revenue Service (IRS). On May 4, 2006, the IRS released Revenue Ruling 2006–27, which will likely lead the IRS to rescind the nonprofit status of a large number of nonprofits who receive funding from property sellers in providing downpayment assistance to FHA borrowers. FHA regulations require that nonprofits providing a downpayment gift have an IRS nonprofit exempt status. Due to the ruling, the IRS has indicated that it is investigating 185 organizations which provide downpayment assistance.

MBA expects this ruling to have a dramatic effect on FHA's purchase production. Currently, more than one-third of FHA purchase loans have the type of downpayment assistance that will be affected by the IRS ruling. Such programs currently serve tens of thousands of FHA's primary clientele: first-time home buyers, low- and moderate-income families and minorities.

MBA does not dispute the ruling by the IRS but we are concerned about the families that will find affordable financing unavailable to them and implore Congress to give FHA the authority to serve these families through a flexible downpayment program this year.

MBA has taken great efforts to inform our membership about the impact of the IRS ruling, and the responses of our members have been strong. Mortgage lenders want to be able to serve these families directly with an FHA product that allows for flexible downpayments. On May 15, 2006, MBA, along with nine other trade associations, sent a coalition letter to members of the House, urging them to co-sponsor H.R. 5121. We have heard that over 12,000 mortgage industry professionals contacted their representatives during May urging them to support H.R. 5121. Clearly, Congressional action on FHA reform this year is vital.

On behalf of MBA, I would like to thank the Subcommittee for the opportunity to present MBA's views on the important programs offered by FHA. MBA looks forward to working with Congress and HUD to improve FHA's ability to serve aspiring homeowners and those seeking affordable rental housing.

PREPARED STATEMENT OF TOM STEVENS

PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

JUNE 20, 2006

Senator Allard, Senator Reed and the Members of the Subcommittee, My name is Tom Stevens, and I am the former President of Coldwell Banker Stevens (now known as Coldwell Banker Residential Brokerage Mid-Atlantic)—a full-service realty firm specializing in residential sales and brokerage. Since 2004, I have served as Senior Vice President for NRT Inc., the largest residential real estate brokerage company in the nation.

As the 2006 President of the National Association of REALTORS®, I am here to testify on behalf of our nearly 1.3 million REALTOR® members. We thank you for the opportunity to present our view of the FHA program and the need for reform. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the nation's housing stock and making it available to the widest range of potential home buyers. The Association has a long tradition of support for innovative and effective Federal housing programs and we work diligently with the Subcommittee and the Congress to fashion housing policies that ensure Federal housing programs meet their mission responsibly and efficiently.

FHA's single-family mortgage insurance program is a valuable government program that has proved highly beneficial in helping low-, moderate-, and middle-income people achieve the dream of home ownership. FHA insurance is available to individuals regardless of their racial, ethnic, or social characteristics and its universal availability helps stabilize housing markets when private mortgage insurance is nonexistent or regional economies encounter disruptions. FHA's underwriting standards are more flexible than the conventional market, allowing more borrowers to qualify for mortgages. We believe that the FHA program can be empowered with tools to close the minority home ownership gap and provide home buyers with alternatives to risky loan products currently being provided by the conventional and subprime markets.

FHA was established in 1934 to provide an alternative to home buyers. At that time in our history short-term, interest-only and balloon loans were prevalent. FHA was created to provide long-term, fixed-rate financing. These same conditions exist today, warranting the continued existence and viability of FHA.

FHA's market share has dwindled because its loan limits, inflexible downpayment requirement, and fee structure have not kept pace with the current mortgage marketplace. As a result, a growing number of home buyers are deciding to use one of several new types of specialty mortgages that let them "stretch" their income so they can qualify for a larger loan. Specialty mortgages often begin with a low introductory interest rate or payment plan a "teaser"—but the monthly mortgage payments are likely to increase significantly in the future. Some are "low documentation" mortgages that provide easier standards for qualifying, but also feature higher interest rates or higher fees. Mortgages such as interest-only and option ARMs can often be risky propositions to borrowers. These pose severe risk burdens to consumers who may be unable to afford the mortgage payment in the future because monthly payments may increase by as much as 50 percent or more when the introductory period ends, or cause their loan balance (the amount you still owe) to get larger each month instead of smaller. According to Moody's, more than a quarter of all existing mortgages come up for interest-rate resets in 2006 and 2007.[1] While some borrowers may be able to make the new higher payments, many will find it difficult, if not impossible.

For many of these potential home buyers, FHA can play a major role in meeting their home ownership aspirations without adverse consequences. FHA typically serves borrowers who have lower annual incomes, make smaller downpayments, and purchase less expensive homes. However, FHA's market share has been dropping in recent years. In the 1990s FHA loans were about 12 percent of the market. Today, that rate is closer to 3 percent. As the market has changed, FHA must also change to reflect consumer needs and demands. Conventional and subprime lenders have been expanding their products and offering more types of loans to more types of borrowers. However, not all of these loans are in the best interest of the borrower. If FHA is enhanced to conform to today's mortgage environment, many borrowers would have available to them a viable alternative to the riskier products that are marketed to them.

In recent years the subprime mortgage market has exploded. In 2003, subprime loans accounted for 8.5 percent of the market. In 2005, their share was 20 percent. Subprime loans are not inherently bad. The subprime market has a very important role to play for many borrowers. Subprime loans allow many home buyers who could not otherwise get into a home achieve the dream of home ownership. But, as FHA has declined to be a player in the mortgage market, more and more borrowers have taken out subprime loans, when they would have qualified for FHA at a lower overall cost. In the first quarter of this year, FHA lost almost 38 percent of its market share, the conventional market lost almost 10 percent, while the subprime market gained nearly 16 percent. American home buyers need to have affordable alternatives, such as FHA available to them.

While the home ownership rate continues to rise, there are still many hard-working families that simply cannot qualify for a conventional mortgage. Minority home ownership rates are significantly lower than the national average—around 50 percent, compared with nearly 70 percent for the Nation as a whole. The home ownership rate for African-American households in the first quarter of 2005 was 48.8 percent, while Hispanic households were at 49.7 percent. The home ownership rate for Asian, Native Americans, and Pacific Islanders was 59.4 percent. By comparison, 76.0 percent of non-Hispanic whites were homeowners.

Recently the Center for Responsible Lending released a study[2] that demonstrated that minorities are 30 percent more likely to receive a higher-priced loan than white borrowers, even after accounting for risk. African-Americans were more likely to receive higher-rate home purchase and refinance loans than similarly situated white borrowers, particularly for loans with prepayment penalties. For Latinos it was even worse. According to the study, Latinos were 29 to 142 percent more likely to receive a higher-cost loan than whites of similar risk.

A study by the National Community Reinvestment Coalition[3] found similar results. Its study found that of all the conventional loans made to African-Americans,

[1] "Millions are Facing Monthly Squeeze on House Payments," Wall Street Journal, March 11, 2006, page 1.

[2] *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages, Center for Responsible Lending,* May 31, 2006.

[3] *The 2005 Fair Lending Disparities: Stubborn and Persistent II*, National Community Reinvestment Coalition, May 23, 2006.

54.5 percent were high-cost loans, while only 23.3 percent of whites had high-cost loans. FHA insurance is available to individuals regardless of their racial, ethnic or social characteristics. Nearly 30 percent of FHA's market is minority home buyers, compared to only 17 percent of the conventional market.

Finally, a report by the Consumer Federation of America [4] determined that African-American and Latinos are more likely to obtain payment option mortgages. Latinos were twice as likely to obtain payment option mortgages as non-Latinos and African-Americans were 30 percent more likely to obtain payment option mortgages than non-African-Americans. With regard to borrower income levels, CFA discovered that 37 percent of interest only borrowers and 35 percent of option payment borrowers had incomes below $70,000. If revitalized, FHA can help bridge the gap in minority home ownership and provide alternative options that help fight against predatory or discriminatory loans.

To enhance FHA's viability, the Administration is proposing a number of important reforms to the FHA single-family insurance program that will greatly benefit home buyers nationwide. FHA is proposing to eliminate the statutory 3 percent minimum cash investment and downpayment calculation, allow for extended loan terms from 30 to 40 years, allowing FHA flexibility to provide risk-based pricing, move the condo program into the 203(b) fund, and increase the loan limits. The National Association of REALTORS® strongly supports these reform provisions.

The ability to afford the downpayment and settlement costs associated with buying a home remains the most challenging hurdle for many home buyers. Eliminating the statutory 3-percent minimum downpayment will provide FHA flexibility to offer varying downpayment terms to different borrowers. Although housing remains strong in our nation's economy and has helped to increase our nation's home ownership rate to a record 69 percent, many deserving American families continue to face obstacles in their quest for the American dream of owning a home. Providing flexible downpayment products for FHA will go a long way to addressing this problem.

In 2005, 43 percent of first-time home buyers financed 100 percent of their homes. NAR research indicates that if FHA were allowed to offer this option, 1.6 million families could benefit. According to NAR's Profile of Home buyers, 55 percent of home buyers who financed with a zero-downpayment loan in 2005, had incomes less than $65,000; 24 percent of those who used a zero-downpayment product were minorities; and 52 percent of people who financed 100 percent of their home purchased homes priced at less than $150,000.

FHA has allowed borrowers to receive their downpayment assistance through an approved gifting source. However, the IRS recently ruled that many seller-funded downpayment programs would lose their charitable tax status, making them ineligible for FHA usage. It has been estimated that 29 percent of FHA borrowers in 2005 used seller-funded downpayment assistance. Studies done by Government Accountability Office and others determined that this form of downpayment assistance in fact drove up the costs of home ownership, and generally made the loan a bigger risk. Instead, by providing FHA the ability to offer flexible downpayments, homeowners won't bear this increased cost, and, along with the flexibly pricing proposal, FHA could price such a product according to risk, as is done in the conventional market.

FHA mortgages are used most often by first-time home buyers, minority buyers, low- and moderate-income buyers, and other buyers who cannot qualify for conventional mortgages because they are unable to meet the lender's stringent underwriting standards. Despite its successes as a home ownership tool, FHA is not a useful product in high-cost areas of the country because its maximum mortgage limits have lagged far behind the median home price in many communities. As a result, working families such as teachers, police officers and firefighters are unable to buy a home in the communities where they work.

Under the Administration's proposal, FHA's limits for single unit homes in high-cost areas would increase from $362,790 to the 2006 conforming loan limit of $417,000. Research conducted by the National Association of REALTORS® indicates that this will result in 28 percent more FHA originations in California and 19 percent more originations in Massachusetts.

In non-high-cost areas, the FHA limit (floor) would increase from $200,160 to $271,050 for single unit homes. This increase will enhance FHA's ability to assist home buyers in areas not defined as high-cost, but where home prices still exceed the current maximum of $200,160. This includes the states of Arizona, Colorado, Florida, Georgia, Illinois, Maine, Minnesota, Nevada, North Carolina, Ohio, Oregon, Pennsylvania, Utah, Vermont, and Washington. While none of these states is gen-

[4] Exotic or Toxic? An Examination of the Non-traditional Mortgage Market for Consumers and Lenders, Consumer Federation of America, May, 2006.

erally considered "high cost", all have median home prices higher than the current FHA loan limit.

Another key component of the Administration's proposal is to provide FHA with the ability to charge borrowers different premiums based on differing credit scores and payment histories. Risk-based pricing of the interest rate and fees and/or mortgage insurance is used in the conventional and subprime markets to manage risk and appropriately price products based on an individual's financial circumstances. Currently, all FHA borrowers, regardless of risk, pay virtually the same premiums and receive the same interest rate.

The legislation will allow FHA to differentiate premiums based on the risk of the product (*e.g.,* amount of cash investment) and the credit profile of the borrower. These changes will enable FHA to offer all borrowers choices in the type of premium charged (*e.g.,* annual, upfront, or a hybrid that includes both an upfront and annual premium structure) and will permit FHA to reach higher-risk borrowers (by charging them a premium amount commensurate with risk), and continue to accommodate the better credit risks, by charging them less. FHA financing, with risk-based premium pricing, will still be a much better deal for borrowers with higher risk characteristics than is currently available in the "near prime" or subprime markets. Risk-based pricing makes total sense to the private market, and should for FHA as well.

It is also important to note that, while FHA has had the authority to charge premiums up to 2.25 percent, they have not done so. FHA currently charges 1.5 percent. The FHA Fund is strong and has continued to have excess revenue, so there has not been a need to increase the premiums. Opponents argue that FHA is seeking to increase premiums to make money, gouging lower-income borrowers. Giving FHA the flexibility to charge different borrowers different premiums based on risk will simply allow FHA to increase their pool of borrowers. If FHA is also given authority to provide lower downpayment mortgages, premium levels will need to reflect the added risk of such loans (as is done in the private market) to protect the FHA fund.

The Administration also proposes to combine all single-family programs into the Mutual Mortgage Insurance (MMI) Fund. The FHA program has four funds with which it insures its mortgages. The MMI Fund is the principal funding account that insures traditional 203(b) single-family mortgages. The Fund receives upfront and annual premiums collected from borrowers as well as net proceeds from the sale of foreclosed homes. It is self-sufficient and has not required taxpayer bailouts.

For accounting purposes, the MMI Fund is linked with the Cooperative Management Housing Insurance Fund (CMHI). The CMHI finances the Cooperative Housing Insurance program (Section 213) which provides mortgage insurance for cooperative housing projects of more than five units that are occupied by members of a cooperative housing corporation. FHA also operates Special Risk Insurance (SRI) and General Insurance (GI) Funds, insuring loans used for the development, construction, rehabilitation, purchase, and refinancing of multifamily housing and healthcare facilities as well as loans for disaster victims, cooperatives and seniors housing.

Currently, the FHA condominium loan guarantee program and 203(k) purchase/rehabilitation loan guarantee program are operated under the GI/SRI Fund. NAR strongly supports inclusion of these programs in the MMIF. In recent years programs operating under the GI/SRI funds have experienced disruptions and suspensions due to funding commitment limitations. Because the multifamily housing programs are under the GI/SRI funds and thus susceptible to future funding expirations, maintaining the single-family programs under the GI/SRI funds would expose these programs to possible future disruptions. Thus, from an accounting standpoint, it makes sound business sense to place all the single-family programs under the MMIF.

Besides combining the 203(k) and condominium programs under the MMIF, NAR also recommends key enhancements to increase the programs' appeal and viability. Specifically, NAR recommends that HUD be directed to restore investor participation in the 203(k) program. In blighted areas, homeowners are often wary of the burdens associated with buying and rehabilitating a home themselves. However, investors are often better equipped and prepared to handle the responsibilities related to renovating and repairing homes. Investors can be very helpful in revitalizing areas where homeowners are nervous about taking on such a project.

We also recommend that HUD lift the current owner-occupied requirement of 51 percent before individual condominium units can qualify for FHA-insured mortgages. The policy is too restrictive because it limits sales and home ownership opportunities, particularly in market areas comprised of significant condominium developments and first-time home buyers. In addition, the inspection requirements

on condominiums are burdensome. HUD has indicated that it would provide more flexibility to the condo program under the MMIF. We strongly support loosening restrictions on FHA condo sales and 203(k) loans to provide more housing opportunities to home buyers nationwide.

In today's market, interest rates are low, home prices are rising, and lenders have expanded their pool of tools to offer borrowers. But will these options still be available during periods of economic uncertainty? FHA has been there for borrowers. When the housing market was in turmoil during the 1980s, FHA continued to insure loans when other left the market. Following Hurricanes Katrina and Rita, FHA provided a foreclosure moratorium for borrowers who were unable to pay their mortgages while they recover from the disaster.

The universal and consistent availability of FHA is the principal hallmark of the program that has made mortgage insurance available to individuals regardless of their racial, ethnic, or social characteristics during periods of economic prosperity and economic depression. FHA's universal availability helps stabilize housing markets when private mortgage insurance is nonexistent or regional economies encounter disruptions. FHA is the only national mortgage insurance program that provides financing to all markets at all times.

FHA also works to protect borrowers against foreclosure. FHA provides financial incentives to lenders who use HUD's loss mitigation program to help homeowners keep their homes. FHA's loss mitigation program authorizes lenders to assist borrowers in default and reduce losses to the FHA fund. These programs include mortgage modification and partial claim. Mortgage modification allows borrowers to change the terms of their mortgage so that they can afford to stay in the home. Changes include extension of the length of the mortgage or changes in the interest rate. Under the partial claim program, FHA lends the borrower money to cure the loan default. This no-interest loan is not due until the property is sold or paid off. In the year 2004 alone, more than 78,000 borrowers were able to retain their home through FHA's loss mitigation program.

The NATIONAL ASSOCIATION OF REALTORS® recognizes that home ownership is a primary goal of American families. Housing has always been and continues to be one of the highest personal and social priorities in America with study after study affirming that a large proportion of Americans would rather own than rent a home. Home ownership directly benefits society by fostering pride and participation in one's community, encouraging savings, and promoting social and political stability. Home ownership has been emulated on television, romanticized in literature, and coveted in the popular social consciousness. It is advocated by private enterprise and encouraged by government policy. Clearly, it is the proud achievement of most American families, the ultimate assimilation for generations of immigrants to this country, and the pinnacle for Americans generally as they climb the ladder of economic success.

The NATIONAL ASSOCIATION OF REALTORS® applauds the private sector for the recent development of innovative and affordable housing products that are providing housing opportunities for many deserving families. However, not all needs are being met, and some homeowners may not be in a loan that is appropriate for them. Consequently, the NATIONAL ASSOCIATION OF REALTORS® steadfastly maintains that government mortgage programs in general and the FHA in particular represent the most important source of home ownership for many American families. FHA is currently a lender of last resort. Without reforms to the program, first-time home buyers, minorities, and home buyers with less than perfect credit are left with fewer and fewer safe, affordable options. FHA is a safe product at a fair price. We need reforms to the program that make FHA a viable mortgage product for today's home buyers. We urge you to seriously consider these reforms to the FHA single-family home loan guarantee program to ensure all homeowners are afforded the true dream of home ownership.

In conclusion, the National Association of REALTORS® commends you, Ranking Member Reed, Chairman Allard, and the Subcommittee for its leadership in fashioning housing policies that stimulate housing opportunities for deserving families. The NAR stands ready to work with you in crafting legislation that furthers the mission of the FHA single-family mortgage insurance program.

PREPARED STATEMENT OF A.W. PICKEL, III

PRESIDENT AND CHIEF EXECUTIVE OFFICER, LEADERONE FINANCIAL CORPORATION, ON BEHALF OF THE NATIONAL ASSOCIATION OF MORTGAGE BROKERS

JUNE 20, 2006

Good afternoon Chairman Allard and members of the Subcommittee, I am A.W. Pickel, III, past President of the National Association of Mortgage Brokers (NAMB). Thank you for inviting NAMB to testify today on the Federal Housing Administration: Issues for the Future. In particular, we appreciate the opportunity to address the need to: (1) increase Federal Housing Administration (FHA) loan amounts for high-cost areas, (2) develop risk-based pricing for mortgage insurance on FHA loans, and (3) reform the FHA program to reduce the barriers to mortgage broker participation.

NAMB is the only national trade association exclusively devoted to representing the mortgage brokerage industry. As the voice of the mortgage brokers, NAMB speaks on behalf of more than 25,000 members in all 50 states and the District of Columbia.

America enjoys an all-time record rate of home ownership today. Mortgage brokers have contributed to this achievement as we work with a large array of home buyers and capital sources to originate the majority of residential loans in the United States. At the end of last year, the overall home ownership rate neared 70 percent. This is an astounding number until one realizes that the home-ownership rate for Hispanics is just over 50 percent and for African-Americans, is only 48 percent. Many families still need assistance in obtaining home ownership and NAMB believes that the proposed reforms to the FHA program are critical to expanding home ownership opportunities for prospective first-time, minority, and low- to moderate-income home buyers.

FHA Utilization of Mortgage Brokers

NAMB supports the U.S. Department of Housing and Urban Development's (HUD) proposed reforms to the FHA program (Proposal), but believes that the FHA program must first be a viable option for prospective borrowers. Regardless of how beneficial a loan product may be, it requires an effective distribution channel to deliver it to the marketplace. Unfortunately, many prospective borrowers are denied the benefits offered by the FHA program because mortgage brokers—the most widely used distribution channel in the mortgage industry—are limited in offering FHA loan products.

According to Wholesale Access, mortgage brokers originated 38.6 percent of all FHA loans for a total of $110 billion in 2003. Mortgage brokers want to further increase origination of FHA loan products for first-time, minority and low- to moderate-income home buyers. However, current financial audit and net worth requirements create a formidable barrier to mortgage broker participation in the FHA program. This barrier makes it difficult for mortgage brokers to offer FHA loan products to those borrowers that could clearly benefit by participating in the FHA program.

NAMB supports increased access to FHA loans so that prospective borrowers who may have blemished or almost non-existent credit histories, or who can afford only minimal downpayments, have increased choice of affordable loan products and are not forced by default to the subprime loan market. In this spirit, NAMB believes the audit and net worth requirements should be eliminated for mortgage brokers that want to offer FHA loan products to consumers.

First, current FHA requirements impose cost prohibitive and time consuming annual audit and net worth requirements on mortgage brokers that want to originate FHA loans. These requirements place serious impediments in the origination process that functionally bar mortgage brokers from distributing FHA loans to the marketplace, leaving subprime loan products as the only other option for many borrowers.

Most small businesses find the cost to produce audited financial statements a significant burden. An audit must meet government accounting standards and only a small percentage of certified public accountants (CPAs) are qualified to do these audits. Moreover, because many auditors do not find it feasible to audit such small entities to government standards, even qualified CPA firms are reluctant to audit mortgage brokers. Cost is not the only factor. A mortgage broker can also lose valuable time—up to several weeks—preparing for and assisting in the audit. Between the cost of hiring an accountant who meets government auditing standards and is willing to conduct the audit and the hours needed to compile and report the needed data, it is simply impractical for a small business to conduct this type of financial audit.

The net worth requirement for mortgage brokers is also limited to liquid assets because equipment and fixtures depreciate rapidly and loans to officers and goodwill are not permitted assets. To compound this, a broker who greatly exceeds the net worth requirement is forced to keep cash or equivalents of 20 percent of net worth up to $100,000. There has been no evidence presented by FHA that loans originated by high net worth originators perform better than those with a lower net worth.

Moreover, annual audit and net worth requirements are unnecessary. Originators are already governed by contract agreements with their respective FHA-approved lenders, affording HUD adequate protection against loss. FHA-approved lenders already submit to audits, thereby ensuring that customers are protected and can seek relief from dishonest originators.

In sum, the audit and net worth requirements are prohibitively expensive for a large majority of mortgage brokers and as a direct result, many brokers have been left with little choice but to originate loans other than FHA. As a result, the audit and net worth requirements actually limit the utility and effectiveness of the FHA program and seriously restrict the range of choice available for prospective borrowers who can afford only a minimal downpayment. At a minimum, NAMB believes annual bonding requirements offer a better way to ensure the safety and soundness of the FHA program than requiring originators to submit audited financial statements.

Second, FHA's formal position is that it only approves lenders to originate FHA loans. FHA does not even acknowledge the term "mortgage broker" in its guidelines and therefore, no provision currently exists that would explicitly permit mortgage brokers to originate FHA loans. In fact, until several years ago, FHA required all loans to be closed in the name of the originating party. Fortunately, this prohibition was somewhat alleviated when FHA allowed the loan to close in the name of the actual source of the funds. Today, anyone who originates, but is not the ultimate source of funds, is referred to as a "Correspondent Lender"—a term normally only used for mortgage bankers.

A stated objective of HUD, and the FHA program, is to increase origination of FHA-loan products and expand home ownership opportunities for first-time, minority, and low- to moderate-income families. NAMB believes the solution to increase FHA loan production is simple—allow more stores, such as mortgage brokers, to offer FHA loan products directly to consumers. As stated previously, mortgage brokers originate the majority of all residential loans and therefore, would provide HUD with the most viable and efficient distribution channel to bring FHA loan products to the marketplace.

FHA Risk-Based Premiums are Relevant to the Market

The ability to match borrower characteristics with an appropriate mortgage insurance premium has been recognized as essential by every private mortgage insurer (PMI). PMI companies have established levels of credit quality, loan-to-value, and protection coverage to aid in this matching process. They also offer various programs that allow for upfront mortgage insurance premiums, monthly premiums or combinations of both. This program flexibility has enabled lenders to make conventional loans in the private marketplace that either are not allowable under FHA or that present a risk level that is currently unacceptable to FHA.

Unfortunately, where FHA is not available as a viable competitor, PMI premiums are quite expensive. Should FHA decide to enter this market, it will increase competition for these programs and ultimately, drive down costs for borrowers.

For example, many mortgage products that require minimal or no downpayment or equity do not use PMI insurance. Rather, these loans are split into two—a first mortgage, which is offered at a lower interest rate, and then a second mortgage offered at a considerably higher interest rate. This "combo" or "80/20" type of mortgage product is commonly offered to borrowers with less than perfect credit. Borrowers who are unable to adequately prove their income also commonly utilize "combo" mortgages. In this market, PMI may not be offered or is offered at a prohibitively high premium. Again, FHA could act as a competitor to drive down costs for these types of products.

PMIs have demonstrated the ability to balance risk with the premiums charged and the FHA program should be afforded the same opportunity. If the risks are assessed appropriately, the premiums charged should ensure that the Mutual Mortgage Insurance Fund (MMIF) will not be adversely affected. FHA is not required to make a suitable profit or demonstrate market growth to shareholders; therefore, it is likely that FHA can afford to assume even greater risk levels than PMIs can currently absorb. This increased capacity to assume and manage risk will allow FHA to serve even those borrowers who presently do not have PMI available as a choice.

This Proposal also allows FHA to offer lower premiums to lower-credit-risk home buyers, which will have the net effect of reducing the overall default rates at FHA. Recent changes made by HUD such as permitting formerly non-allowable fees to be charged and utilizing Fannie Mae appraisal guidelines have had the effect of modernizing the FHA program. These advances make the FHA program easier to use, which in turn attracts more borrowers who would not otherwise tolerate the red-tape long-associated with origination of FHA loans. Real estate agents, sellers and mortgage companies who have not viewed FHA financing as a viable alternative to the private marketplace would also return to the program, bringing with them suitable borrowers that would make FHA's default rate comparable to that of conventional loans.

Because a substantial body of data for risk-based lending is available, this Proposal is not a leap into the unknown. Rather, it creates a venue to bring FHA into parity with what has already proven to be reasonable assumption of risk for the marketplace.

This Proposal is not intended to be a change to the FHA program that will create losses. Rather, it is designed to avoid losses to the MMIF. The Proposal contains needed reforms that will help FHA meet its chartered mandate of increasing home ownership opportunities for first-time, minority, and low- to moderate-income home buyers, and which may actually have the side effect of improving the solvency of the MMIF.

All insurance constructs involve assumption of risk. When an insurer can use sound actuarial data and price in a manner that is responsive to trends revealed by such data, the risk is spread over a sufficiently large base to minimize the chance of loss. Because FHA's share of the market is approaching marginal levels, the risks to the program are likely to be greater under the status quo than with the Proposal.

Benefits to Consumers, Particularly First-Time Home Buyers, Minority, and Low- to Moderate-Income Families

Lenders and insurers tend to demand a higher proportional return when they enter a riskier market. It has been demonstrated that the return demanded is considerably higher for subprime loan products than for prime loans because of the inherent risks presented by the subprime market. At the same time, consumer advocates have claimed that fees and rates for many subprime borrowers are too high. FHA has the ability to enter into the subprime market safely and still offer significant savings to prospective borrowers. The benefits received by expanded FHA entry into the subprime market would be particularly useful for first-time, minority and low- to moderate-income home buyers who could receive prime interest rates on their loans by using FHA insurance.

The FHA program also possesses many attributes that are particularly friendly to prospective borrowers who may have less money available for closing costs, temporary income, or a limited credit history. For example, FHA Direct Endorsement Underwriters are given considerable latitude to make loans that they believe should be made, but may not have all of the requisite attributes conventional guidelines require. FHA servicing is far less likely to quickly send a loan to foreclosure and must follow borrower-friendly practices whereas some conventional lenders have been cited for questionable loan servicing practices. FHA loans usually offer fixed-interest rates compared to the adjustable rates offered on most subprime mortgages.

Complements the Private Sector

As discussed earlier, America is built on the concept that competition is healthy for the market. It improves efficiency and quality while offering more competitively priced products to consumers. Making FHA more competitive will improve the services and products provided by other lenders and insurers in the industry. Consumers will be offered FHA programs that serve a similar purpose but are certainly not identical to conventional programs now available. This healthy level of competition should drive down the cost of programs that serve those with minimal downpayments or who need flexible underwriting to obtain home financing.

Borrowers who can afford larger downpayments or who have reasonable equity levels do not find the FHA program to be a reasonable alternative to conventional financing. Nearly all FHA borrowers have a loan-to-value ratio in excess of ninety percent. Since 1980, FHA has never served more than fifteen percent of the total housing market but, at times, it insured nearly fifty percent of urban mortgages. Clearly, the Proposal will not make the FHA program a threat to the overall mortgage market. At most, this Proposal will help to restore FHA loan product origination to levels of previous years.

Nevertheless, the possibility that FHA could supplant certain conventional loans does exist. Such a result is inevitable if FHA regains market share. However, the

conventional loans most likely to be supplanted are those made to borrowers who fall just short of receiving A-grade conventional loans. Many first-time, minority, and low- to moderate-income home buyers find themselves in this situation but are forced to turn to the subprime market to achieve home ownership. This Proposal makes FHA loan products a viable alternative for these prospective borrowers.

The Elimination of the Down Payment Requirement

NAMB supports eliminating the downpayment requirement and granting FHA the flexibility to offer 100 percent financing to aid in the effort to increase home ownership for first-time, minority, and low- to moderate-income families.

Home ownership is a dream that many wish to experience, but for years barriers have existed that prevent many low-income and minority families from purchasing a home. In fact, a recent study published in March 2006 by the Center for Housing Policy [1] reveals that many working minority families with children are less likely to achieve the dream of home ownership today than in the 1970s. A principal barrier to achieving home ownership for these families is financial—the lack of money for a downpayment and closing costs. The Proposal to eliminate the downpayment requirement will help break down this financial barrier for many low- to moderate-income and minority families. This Proposal will help significantly to achieve the Administration's stated goal of increasing minority home ownership by 5.5 million by 2010.

Future of the FHA Program If Proposal Is Enacted or Not Enacted

Proposed changes are needed to the FHA program to meet its chartered mandate, which is to aid the underserved and underprivileged obtain the dream of home ownership. PMI will dominate the low and zero downpayment market with little competition among the few players in that industry. The subprime mortgage market will fulfill the needs of those unable to obtain PMI insurance. Foreclosure rates could escalate. Minority families and first-time home buyers may be underserved or even shut out of the housing market entirely. It is possible that FHA will have a pool of loans too small to effectively manage risk. Ultimately, FHA could be removed as a helping hand to those who need it the most. The ripple effect of negative consequences could easily extend to the homebuilding industry and to the general economy as well.

On the other hand, Congress has the opportunity to revitalize the FHA program with this Proposal. Borrowers will receive better loan programs at lower interest rates. We strongly urge this committee to support the Proposal.

Increase FHA Mortgage Amounts for High-Cost Areas

Congress and this Administration have made home ownership a priority in this country and indeed, the growth of home ownership in this country has been steadfast for the past few years. Unfortunately, the demand for homes continues to outstrip new housing development and sales of existing homes, causing escalation of home prices. In an environment of rising interest rates, many first-time, minority, and low- to moderate-income home buyers will need the safer and less-expensive financing options that the FHA program can provide. For this reason, NAMB uniformly and unequivocally supports increasing FHA loan limits in high-cost areas.

To accommodate the escalating demand for homes, NAMB believes the formula used to calculate FHA maximum loan amounts should be revised to make the FHA program accessible to those home buyers living in high-cost areas. The benefits of the FHA program should belong equally to all taxpayers; especially those residing in high-cost areas that often are most in need of affordable mortgage financing options.

For example, in California, twenty-nine of the fifty-eight counties are currently at the FHA ceiling of $362,790, with another six counties approaching the ceiling when one factors in the latest escalation in home prices. These twenty-nine counties represent approximately eighty-five percent of California's population, many of whom are struggling to become or remain homeowners in an area where the median house price is currently $535,470. California is not alone. High-cost areas exist in many states across the country. Maryland, for example, has 5 of 24 counties currently at the $362,790 FHA maximum with another seven counties within $1,885 of the limit. Again, these counties represent a great majority of the population for Maryland. Additional states that currently feature counties at or approaching the maximum FHA

[1] The Center for Housing Policy recently released a study entitled "Locked Out: Keys to Home Ownership Elude Many Working Families with Children," in March 2006 which showed that the cost of home ownership outpaced income growth for many low- to moderate-income working families with children.

loan limit include Pennsylvania, Connecticut, New York, and New Jersey among others.

Recognizing high-cost areas with regard to FHA loan limits is not new to this legislative body. Congress already recognizes high-cost areas for FHA loan limits in Hawaii, Alaska, and various U.S. Territories. These areas feature an exception that takes their available loan limit to 150 percent of the current FHA loan limit.

We must not forget that the FHA program was created by the National Housing Act of 1934 with the intent of increasing home ownership and assisting the homebuilding industry. Since its inception, FHA has insured over 33 million loans and is the largest insurer of mortgages in the world. FHA-insured loans are the staple for first-time home buyers. FHA-insured loans are more accommodating to first-time home buyers than other types of loan programs. The program is designed to incorporate flexibility for debt-ratios, income and credit history items not included in the government sponsored enterprise (*i.e.,* Fannie Mae and Freddie Mac) guidelines.

Congress must ensure that FHA-insured loan programs continue to serve as a permanent backstop for all first-time home buyer programs. For this reason, we believe that Congress should create the ability for FHA loan limits to be adjusted up to 100 percent of the median home price, thereby providing a logical loan limit that will benefit both the housing industry and the consumer. Tying the FHA loan limit to the median home price for an individual county, and letting it float with the housing market, allows the FHA loan limits to respond to changes in home prices instead of some esoteric number computed through a complicated formula. In this fashion, the FHA loan limit will reflect a true home market economy. Rather than restrict purchases of new homes through a legislatively mandated ceiling, the FHA loan limit can automatically adjust under current guidelines established for increasing the FHA loan limit on a county-by-county basis.

Conclusion

NAMB appreciates the opportunity to offer our views on the FHA program. I am happy to answer any questions.

PREPARED STATEMENT OF IRA GOLDSTEIN

DIRECTOR OF POLICY AND INFORMATION SERVICES, THE REINVESTMENT FUND

JUNE 20, 2006

Good afternoon. My name is Ira Goldstein and I am the Director of Policy and Information Services for The Reinvestment Fund (TRF). I am honored to be asked to comment on changes proposed for the FHA program and I hope that my remarks help you establish the framework for an FHA program that provides added individual and social benefit.

The organization of which I am part—TRF—is a national leader in the financing of neighborhood revitalization. Founded in 1985, TRF has invested $500 million in the creation and preservation of affordable housing, community facilities, commercial real estate, and renewable energy. Since inception we have financed the creation of more than 12,000 affordable housing units, 15,000 charter school slots, 4.3 million square feet of commercial space, and 250 businesses. We also have been actively involved in research related to various aspects of the housing market.

Our work in the areas of mortgage lending, foreclosure, and predatory lending has been supported through grants from foundations, as well as contracts from local and State governmental entities. The research we do has both a strong data-based component, as well as a qualitative component that brings us personally in touch with people from all sectors of the mortgage lending process—from the borrower to the broker to the lender to the servicer and securitizer to the attorneys who represent borrowers and those who represent lenders to the sheriffs who auction off properties on which homeowners are no longer paying their mortgage.

Home ownership is undeniably the critical component in the accumulation of wealth for most American families. Over the last 40 years, home ownership has risen from 63 percent in 1965 to 69 percent in 2005; the number of homeowners has risen from 36 million to 75 million—a 108 percent increase—over that same time. Much of that rise is among minority households and households of lower and moderate income. At the same time, typical home prices in the United States between 1968 and 2005 (or virtually any other period in between) rose substantially faster than inflation. So as a nation we have more people owning an asset that is yielding true appreciation.

Going forward, the demographic groups available to become homeowners are younger, lower income, and minority households. These are the groups currently with the lowest ownership rates. These are also households that statistically have

least net worth. So many who have recently and will in the future become owners are least able to weather the financial impact of a significant financial event such as often occurs with new homeowners.

I think that it is important to think of the proposed changes to the FHA in the larger social context of whether we're approaching (or have passed) the peak societal benefit of home ownership. As former Federal Reserve Governor Gramlich stated "There is a valid debate as to whether continuing to increase overall home ownership rates much further is feasible or even desirable."[1]

Legislation under consideration would seek to raise the home ownership rate through a variety of products and processes, essentially leveling the playing field so that FHA can effectively compete with the subprime mortgage market. One such change is zero-downpayment mortgages. That's important because so few Americans are saving and household debt service ratios are currently at such high levels. The evidence seems to be fairly clear that those zero-down loans have a much higher probability of failure. Our review of the foreclosures in the cities of Philadelphia and Baltimore and State of Delaware suggests that people who purchased homes with two mortgages—one covering the downpayment—were prominently represented among those in foreclosures. According to reports from Fitch Ratings, those products we now call "exotic" mortgages work well for higher net worth individuals seeking to manage their finances more advantageously; they are very risky for the person who is trying to afford a home for which they are only marginally qualified.

With respect to the proposal that FHA adopts a risk-based pricing approach, that is an idea that I think is certainly supportable—assuming that the models are properly conceived, developed, and monitored. The problematic part of the risk-based pricing model is that the price only compensates the lender for the risk the borrower presents. In the end, assuming the model is correct, the lender and FHA can make money even if some borrowers default. But that assumes that no one other than the borrower and the lender matter. Research conducted by TRF and EConsult Corporation—commissioned by the Federal Reserve Bank of Philadelphia—shows that there is a statistically demonstrable adverse effect of mortgage foreclosures on local property markets. In fact, after applying an appropriate set of statistical controls, we found that each foreclosure within ⅛ of a mile of a sale and 1–2 years prior to that sale reduces the value of the home by 1 percent. In Philadelphia, the typical home sale has 4–5 foreclosures within the specified time and distance and so it is reduced by more than 5 percent. The implication of this is that everyone within the area has lost some of the wealth. This is not an argument against risk-based pricing; it is an argument to consider the social costs beyond those of the transaction.

My final point has to do with servicing. It is a well-settled fact that certain servicing and loss-mitigation techniques increase the likelihood that a delinquent loan returns to paying status (*e.g.,* early intervention or reasonable access of borrowers to their servicers)—or that loss to the investor is minimized. The servicing and loss-mitigation efforts on FHA loans are not the best, and TRF's work with practitioners suggests that HUD has not enforced compliance with its current procedures. Even assuming they were complied with, the rules themselves are flawed. Pennsylvania's Homeowners' Emergency Mortgage Assistance Program (not currently available to people with FHA loans) is a remarkably successful example of a loss mitigation strategy that in the case of FHA could reduce claims against the FHA insurance pool. Servicing and loss mitigation takes on added importance if FHA expands its current customer base, as it is proposed. This legislative body can and should require accountability on the servicing and loss mitigation efforts on FHA loans to ensure that with the enhanced risk these new loans create that all efforts are made to keep the loans in a paying status. There will be a cost to an added servicing burden undoubtedly passed on to the consumer, but that cost would likely be justified by increasing the likelihood that a homeowner can keep their home through a financial hardship.

In closing, success is not just changing the rules so that FHA can originate more loans or compete with subprime lending. Success would be that FHA replaces those products within the subprime mortgage market that disadvantage borrowers, with products and processes that enhance the likelihood of sustainable home ownership.

Thank you.

[1] Remarks by Governor Edward Gramlich at the Home Ownership Summit of the Local Initiatives Support Corporation (11.8.01).

PREPARED STATEMENT OF BASIL N. PETROU

MANAGING PARTNER, FEDERAL FINANCIAL ANALYTICS, INC.

JUNE 20, 2006

It is an honor to appear today before this Subcommittee to discuss reform of the Federal Housing Administration (FHA). My comments today will be limited to discussion of the FHA single-family mortgage insurance program. I am managing partner of Federal Financial Analytics, a consulting firm that advises on U.S. legislative, regulatory and policy issues affecting financial institution strategic planning. We thus advise a variety of companies on the implications of legislation and regulation in the mortgage and housing markets. Clients in this practice include trade associations, mortgage insurers, and mortgage lenders.

Key points to consider for FHA reform include:

- As a government program, FHA should serve its targeted borrowers if they are not already being adequately served by the private sector. It is not appropriate for FHA, as a government program, to launch initiatives to expand its "market share."
- Recent General Accountability Office (GAO) and Department of Housing and Urban Development (HUD) Inspector-General reports, as well as the President's fiscal year 2007 budget raise serious questions about the Mutual Mortgage Insurance (MMI) Fund's financial soundness. The most recent available MMI Fund data are for only mid-fiscal year 2005, and these show a serious reduction in the economic value of the fund that undermines its capital adequacy. Mortgage-market trends since then have shown significant weakening, as evident by recent guidance from the Federal bank regulatory agencies designed to protect insured depository institutions.
- The FHA should not seek to grow its way out of its current financial problems. Doing so is reminiscent of the actions taken by distressed savings-and-loans during the 1980s.
- The MMI Fund is already taking financial risks. For example, 50 percent of all FHA loans insured in 2004 had downpayment assistance, with nonprofit organizations that received seller funding accounting for 30 percent of these loans. GAO analysis indicates that these sellers raised the price of their properties to recover their contribution to the seller-funded nonprofit—placing FHA buyers in mortgages that were above the true market value of the house. The Internal Revenue Service (IRS) is curtailing these programs, but the significantly higher claim rates FHA has experienced from these loans will continue for those remaining on its books. Indicative of FHA's problems is that its delinquency rates are higher than those associated with private subprime loans. Adding yet more risk means potentially profound FHA losses that will heighten the risk of calls upon the taxpayer.
- From a budgetary perspective, the MMI Fund now is only breaking even, but even this is based only on out-dated information. Any shift in the MMI Fund's financial condition will convert the program into a net cost to taxpayers, increasing the Federal budget deficit.

Concerns about specific reform proposals made by the FHA and others include:

- Raising FHA area loan limits—both the base limit and high-cost area ones—will not help low- and moderate-income families to become homeowners. Raising the base limit would push the FHA-insured loan amount in low-cost areas to \$271,000 and the income of borrowers qualifying for a mortgage of this size is over \$86,000. Raising the high-cost limit would push the mortgage amount that could be insured by the FHA to \$417,000, which would only reach borrowers with incomes over \$132,000.
- In key markets, raising the base limit would mean that the FHA would insure homes well above the median house price in an entire State. This would further distance the FHA from its mission, as well as expose the MMI Fund to increased risk from regional economic downturns.
- Giving FHA authority to replace its current premium structure with a risk-based premium is a very risky proposition. It raises serious questions about whether some low- and moderate-income borrowers and minorities will be priced out of the entire mortgage market. Further, GAO and HUD reports indicate that FHA does not have the necessary data or analytical capability to establish a successful risk-based premium. A mispriced FHA premium structure

would be devastating to the MMI Fund and the borrowers it was meant to serve.

- Eliminating the 3 percent minimum downpayment requirement must be carefully structured to prevent risk to borrowers, communities, and the rest of the MMI Fund. Careful underwriting is critical. HUD should rely only on proven FHA lenders, validated by increased sampling of the loans they underwrite. A zero downpayment program should begin only as a pilot program and, if subsequently expanded, should always be limited to low- and moderate-income buyers who prove they do not have the necessary 3 percent minimum downpayment.

Although the pending proposed changes to the FHA pose serious concerns, the program can be and should be revised to assure it meets its mission. Recommended changes include:

- It is time that FHA became an income-targeted—rather than a loan amount targeted—housing program. The current system for setting FHA area loan limits is skewed toward raising these limits above the true median house price for an area, never lowering them, even if house prices fall. Income targeting FHA's single-family program will assure that low- and moderate-income borrowers become the primary focus of the program. It should also make housing more affordable for these targeted borrowers.
- The 100 percent Federal guarantee behind FHA insurance undercuts the financial health of the MMI Fund, provides incentives for lax underwriting, and is not needed to make FHA insurance useful for most of its target borrowers.

I now will address in more detail the current health of the FHA and the serious problems posed by several proposals: implementing a zero downpayment program, raising the FHA loan limits and replacing the current premium structure with a risk-based premium.

Implementing a Zero Downpayment Program

- Zero downpayment loans are viewed by the private sector as higher risk, resulting in reliance on careful underwriting. Thus, FHA entry into zero downpayment loans must be carefully structured to prevent risk to borrowers, communities, and the rest of the FHA Mutual Mortgage Insurance (MMI) Fund.
- It is critical to the health of the FHA Fund that the zero downpayment program be designed to bring new borrowers into the FHA, rather than serve as a means for those borrowers who have the wherewithal to make a 3 percent downpayment simply to avoid doing so. Some lenders and real estate brokers may look to the zero downpayment program as a way to move an FHA borrower into a larger mortgage rather than bringing low- and moderate-income potential borrowers who otherwise would not qualify for an FHA-insured loan into a starter home.
- The latest Actuarial Report for the MMI Fund notes that, "nearly 80 percent of the mortgages originated in fiscal year 2005 have LTV ratios of 95 percent or more, and over 85 percent have LTV ratios above 90 percent. LTV ratios between 95 percent and 98 percent comprise the most popular category with 80 percent of loans falling in this range."[1] Clearly, FHA is already exposed to the risk associated with very high LTV loans. The addition of a zero downpayment program will increase this exposure. Thus, an FHA fund with a relatively large share of zero downpayment borrowers would significantly increase the MMI Fund's risk exposure during periods of regional house price declines or economic contraction. For this reason, the program should begin as a pilot program to test the success of FHA's new underwriting criteria.
- Since the zero downpayment borrower starts home ownership owing more on a mortgage than the house is worth, an inflated appraisal puts that borrower further behind the goal of building equity. The combination of a bad appraisal, economic problems for the zero-downpayment borrower and stagnant home values can result in a high level of foreclosures in those inner city and moderate income areas where these FHA mortgages will be concentrated. The result of concentrated foreclosures is further downward pressure on home prices that escalate the downward spiral for that neighborhood.
- To protect borrowers, communities, and the MMI Fund, HUD should impose limits beyond those currently proposed for zero downpayment loans. These

[1] Actuarial Study of the MMI Fund for fiscal year 2005 available on the HUD web site in sections at: *www.hud.gov/offices/hsg/rpts/actr/2005actr.cfm.* Section IV, pp. 38–39.

should include starting the program as a pilot program, targeting it to low- and moderate-income borrowers, limiting it only to proven FHA lenders with low claim rates, and higher sampling rates for these loans.

Financial Condition of the MMI Fund

MMI Fund Actuarial Study

The most recent actuarial study released in early 2006 for fiscal year 2005 [2] indicates the MMI Fund has a 6.2 percent capital ratio but this does not indicate that the Fund is financially healthy:

- Loan data for the second half of the fiscal year was not available and not analyzed.
- The MMI Fund's capital ratio improved from the fiscal year 2004 level because FHA's market share fell. Thus, current and future capital ratios cannot be inferred from this data. FHA's decrease in market share took place at a time when home ownership rates were high and there is no indication that FHA target borrowers were not served by private sector alternatives.
- The Fund's economic value fell by $2.8 billion—11 percent below its projected value from the previous year. The significant decrease in the economic value of the MMI Fund is to a great extent attributable to factors that remain today and actually worsened during the past year.
- Negative factors include an alarming new trend in FHA. Loans with non-relative third-party downpayment assistance comprised 18 percent of FHA's new business for the time covered by the actuarial study and the losses on those loans reduced the MMI Fund's economic value by $1.7 billion.
- A subsequent November 2005 study by the GAO reported that FHA's share of these types of loans was actually 50 percent with 30 percent accounted for by seller contributions to nonprofit organizations.[3] This report also had the disturbing conclusion that "property sellers often raised the sales price of their properties in order to recover the contribution to the seller-funded nonprofit that provided the downpayment assistance. In these cases, home buyers may have mortgages that were higher than the true market value price of the house and would have acquired no equity through the transaction."[4] This fact may partially explain the significantly higher claim rates suffered by these products.

HUD Inspector General Report

A November 2005 HUD Inspector General (IG) report [5] notes the inadequacy of the actuarial study which FHA uses to predict losses. The IG report concluded that FHA does not have enough historical data on the various risk factors of its own borrowers to effectively evaluate loan performance:

- It noted as a material weakness that "FHA must incorporate better risk factors and monitoring tools into its single-family insured mortgage program risk analysis and liability estimation process."[6] Specifically, it found that FHA lacks a formal process to effectively evaluate the impact on the MMI Fund of loan factors, "such as borrower credit scores, downpayment assistance sources, and other portfolio characteristics."[7]
- It concludes that "FHA also cannot determine current risk trends in its active insured mortgage portfolio."[8] That is, FHA is not sure what is driving the current surge in its claims. As a critical example of this failure, the HUD IG notes that the MMI Fund's independent actuary determined that the claim rates for loans where the borrowers received non-relative assistance for the initial loan downpayment was "as high as three times those that did not receive assistance."[9] However, the report concludes that "FHA has not had sufficient data to segregate these loans into a separate risk category for loss estimation purposes."[10]

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[2] Actuarial Study of the MMI Fund for fiscal year 2005 available on the HUD web site in sections at: *www.hud.gov/offices/hsg/rpts/actr/2005actr.cfm.*

[3] GAO–06–24*, Mortgage Financing, Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance.* November 2005.

[4] *Ibid.,* pp.19–20.

[5] Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2005 and 2004, November 7, 2005, Audit Case Number 2006–FO–0002.

[6] *Ibid.,* Appendix A, p. 7.

[7] *Ibid.*

[8] *Ibid.*

[9] *Ibid.*

[10] *Ibid.*

GAO Study of September 2005

A GAO study released in September 2005 detailed the reasons behind a $7 billion reestimate for the MMI Fund.[11]

The points raised in this study include:

- Actual claim activity in fiscal year 2003 exceeded estimated claim activity "by twice as much in some cases—for majority of loan cohorts."[12]
- Events that may explain the reasons for this increase "include changes to underwriting guidelines, competition from the private sector, and an increase in the use of downpayment assistance."[13]
- GAO concludes that while "FHA has taken some steps to tighten underwriting guidelines and better estimate loan performance . . . it is not clear that these steps are sufficient to reverse recent increases in actual and estimated claims and prepayments or help FHA to more reliably predict future claim and prepayment activity."[14]
- Importantly, with respect to future MMI Fund Actuarial reports the GAO notes that "Because the loan performance variables underlying the $7 billion reestimate will likely persist to varying degrees, they are also likely to affect estimates of the Fund's long-term viability . . . if the Fund's economic value declines or is restated at a lower level than previously estimated because of higher claims, and if the insurance in force remains steady, because of declining prepayments, then the capital ratio will decline."[15]
- Finally, with respect to the MMI Fund actuarial analysis, GAO makes the telling point that "neither Congress nor HUD has established criteria to determine how severe a stress test the Fund should be able to withstand."[16]

The President's fiscal year 2007 Budget

The President's fiscal year 2007 budget notes that FHA has serious risk-assessment issues. Specifically, it notes that " . . . the program's credit model does not accurately predict losses to the insurance fund."[17] The results of this failure are serious:

- It shows the impact of the $7 billion reestimates noted above by GAO for each year of business. Each book of business for the last 10 years essentially experienced reductions of 30 percent to 50 percent or more in their net budget impact.[18]
- While the MMI Fund had been estimated last year to generate a net negative subsidy rate of 1.7 percent, the reestimates resulted in the Fund only just breaking even for fiscal year 2007 with a 0.37 percent net negative subsidy rate.[19] The bottom line is that the MMI Fund is on the verge of costing taxpayers money for the first time in its history.
- The budget states that "despite FHA efforts to deter fraud in the program, it has not demonstrated that these steps have reduced such fraud."[20] FHA needs to remedy this problem before it expands through introduction of riskier products to penetrate subprime markets.

GAO Study of April 2006

The latest GAO report on FHA dated April 2006[21] notes technological problems within FHA that raise questions about expanding its operations into riskier markets:

- GAO studied the Technology Open to Approved Lenders (TOTAL) scorecard through which credit factors are input by the loan originator and, if a target

[11] GAO–05–875, *Mortgage Financing, FHA's $7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates.*
[12] *Ibid,* p. 3.
[13] *Ibid.*
[14] *Ibid.*
[15] *Ibid,* pg. 4.
[16] *Ibid.*
[17] Fiscal year 2007 Budget, Analytical Perspectives, Credit and Insurance, p. 70.
[18] Fiscal year 2007 Budget, Federal Credit Supplement, Table 8. Loan Guarantees: Subsidy Reestimates, pp. 51–52.
[19] Fiscal year 2007 Budget, Appendix, p. 556, Table entitled Summary of Loan Levels, Subsidy Budget Authority and Outlays by Program, line 232901.
[20] *Ibid.,* fiscal year 2007 Budget, Analytical Perspective.
[21] *Op. Cit.,* GAO 06–24.

score is achieved, the loan is determined to be eligible for FHA insurance. Otherwise, the loan requires manual underwriting.

- GAO suggested that, conceptually, this system could be used to do risk-based pricing, but HUD is far from ready for use to this effect. In addition, HUD in a March 31, 2006 letter to GAO included in the report notes that, while TOTAL was not intended for risk-based pricing, that FHA "is exploring how it might be used for that purpose," but that "[t]his could be a lengthy exercise with an unknown outcome . . . " and that if FHA is given authority by Congress for new products, FHA "will certainly explore the benefits that TOTAL may present in developing such products."[22]
- The reasons why TOTAL is not ready for risk-based pricing include: antiquated data inputs, absence of a formal plan to update data, absence of key variables such as type of loan instrument type of home and exclusion of data from loans that FHA had rejected. GAO notes that this latter point could mean that a higher percentage of loans that are likely to default will be accepted rather than referred to manual underwriting.

CBO Report of June 14, 2006

- The Congressional Budget Office in its analysis of the FHA Reform bill, H.R. 5121, released on June 14, 2006 reflects the 0.37 percent net negative subsidy rate in its estimate of any additional business that may accrue to FHA as a result of an increase in the loan limits. It is interesting to note that even with a 10 percent annual increase in the volume of FHA borrowers the budget benefits of higher loan limits are minimal—literally only $11 to $15 million a year because of the performance of existing FHA loans. Of course, should FHA performance worsen the estimated budget benefits would turn into budget costs.[23]

High Relative Delinquency Rates

- Delinquency data compiled by the Mortgage Bankers Association for the fourth quarter of 2005[24] shows that FHA loans have a 13.18 percent total delinquency rate versus 2.47 percent for prime conventional loans and 11.73 percent for subprime loans—the market FHA seeks to enter.
- These comparatively high delinquency rates do not augur well for the Fund in light of the problems noted above by GAO and the HUD IG.

Raising FHA Loan Limits

Current FHA Area Limits Are Higher Than Median Area House Prices

- The current structure for setting FHA loan limits is skewed toward setting them at a level above the true area median house price. The current system ties the calculation of the median house price for an MSA to the median house price in the highest cost county within the MSA.[25] The result is that the FHA loan limit for the MSA is clearly not reflective of the true median house price for the entire MSA—it is higher. Moreover, anyone can request a higher limit for the MSA by presenting data to HUD that house prices within a single county within the MSA have gone up to a level above that reflected in the current FHA area loan limit.[26]
- Further aggravating the bias toward an artificially high MSA median house price is that, when data are compiled to show recent house price sales, new house sales are over-weighted. That is, if new house sales comprise less than 25 percent of all house sales in the county and the value of existing house prices is static or declining, then the median price for new houses is calculated separately but given equal weight to the median sales price for existing house sales. Since new home prices are generally higher than existing house sales prices

[22] *Ibid.,* Appendix III, p. 30.
[23] Congressional Budget Office Cost Estimate dated June 14, 2006, *H.R. 5121, Expanding American Home Ownership Act of 2006,* p. 2.
[24] Mortgage Banker's Association, *National Delinquency Survey*, Fourth Quarter, 2005, pp. 10–11.
[25] For FHA limit setting process see HUD Mortgagee Letters 2003–23 and 95–27. As evidence of how quickly real estate brokers and others took advantage of the new law to seek higher area FHA limits see "HUD Raises Limits for FHA-Insured Mortgages in 1999, Numerous Appeals Are in the Works." *Inside Mortgage Finance,* January 8, 1999, page 9.
[26] See HUD web site at *www.hud.gov/offices/hsg/sfh/lender/sfhmolin.cfm.*

this acts to raise the FHA limit above what would be the true area median house price.[27]

Which Borrowers Will Benefit From Even Higher FHA Loan Limits?

- Raising the FHA base loan limit or the FHA high-cost area limit will not allow a borrower with a $50,000 income to qualify for a $271,000 FHA-insured 30-year fixed-rate mortgage—even at today's low—but rising—interest rates. As interest rates rise, the larger FHA loan is placed that much further out of the reach of the moderate-income borrower.
- The base FHA loan limit nationwide is set at 48 percent of the Freddie Mac national loan limit. Today, this is equivalent to a mortgage of $200,160. Thus, even if the median house price in an area is well below $200,000 the FHA will insure loans in that area up to $200,160. On the other hand, the ceiling on the maximum FHA loan amount is set at 87 percent of the Freddie Mac loan limit. Today, this is equivalent to $362,790. This means that, if the FHA process determines that 95 percent of the median house price in an area is greater than $200,160, then that amount will be the FHA limit for that area up to a maximum ceiling of $362,790.
- FHA seeks to raise the FHA base limit to 65 percent of the Freddie Mac national limit and to raise the high-cost area limit to 100 percent of the Freddie Mac limit.[28] Today, this proposal would mean that the base limit would increase from $200,160 to $271,050 and the high-cost area limit would increase to $417,000.
- If we assume a borrower fully qualifies for the FHA loan on an income basis and has no other debt that would act to limit the loan amount for which they would qualify, then, assuming current FHA mortgage rates and average property taxes and property insurance[29] the borrower income needed to qualify for the current $200,160 base FHA loan is over $63,000. Raising the base limit to $271,050 would mean that the base limit would reach borrowers with incomes of over $86,000. For the current FHA high-cost area loan of $362,790, the needed borrower income is over $115,000. Raising the high-cost area limit to $417,000 would mean that the FHA loan would reach borrowers with incomes of over $132,000.
- No matter how one looks at the proposed new FHA loan limits they target the top level of individual taxpayers on a nationwide basis. IRS data for 2003 shows that only the top 8.8 percent of all individual income tax returns had adjusted gross income of over $100,000 and only 16 percent had incomes over $75,000.[30] Furthermore, looking only at individual income tax returns with adjusted gross income between $75,000 and $100,000, we find that 70 percent of these returns reported a deduction for home mortgage interest—indicating that the filer already owned a residence with a mortgage—and 72 percent took a deduction for real estate taxes, indicating that they owned a residence. For returns with incomes between $100,000 and $200,000 the percentage reporting a home mortgage interest deduction was 79 percent and the percentage paying real estate taxes was 85 percent.[31] In short, if the FHA base and high-cost area limits are raised to the levels suggested by the FHA Commissioner, then the borrowers taking advantage of these higher limits are almost assuredly not first-time home buyers and are certainly not buyers with low, moderate or middle tier incomes.

Raising the FHA Base Loan Limit Causes Special Problems

- The critical policy issue for Congress to consider is whether raising the base limit of FHA in low-cost areas to 65 percent of the Freddie Mac nationwide limit will bring in more first-time, low- and moderate-income and minority home buyers or otherwise serve these borrowers. Across the country the current FHA base loan limit of $200,190 is now higher—often significantly higher—than the

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[27] FHA has proposed shifting the FHA area limit calculation from 95 percent to 100 percent of "median house price" as calculated under the existing formula. This change would aggravate the current distortion in the calculation.

[28] See Testimony of FHA Commissioner Montgomery before the Housing Subcommittee of the House Financial Service Committee on April 5, 2006, p. 5.

[29] Interest rate of 6.75 percent for a 30-year fixed-rate FHA loan. Annual property taxes and insurance were assumed at a combined 2 percent of house price. FHA's recently raised income ratio of 31 percent was also factored into these calculations.

[30] See Individual Income Tax Returns, 2003, article by Michael Parisi and Scott Hollenbeck, available on the IRS web site at *http://www.irs.gov/pub/irs-soi/03indtr.pdf.*

[31] *Ibid.*

median existing house price.[32] Raising the FHA base limit to 65 percent of the GSE loan limit would move the FHA limit for these areas to $271,000—two to three times the current median existing house price in many areas.

- Entire states—for example Texas, Louisiana, and Mississippi—are now within the FHA base limit. Analysis of NAR median existing sales price data shows that raising the FHA base limit to $271,000 would bring roughly 83 percent of the metropolitan areas it covers within the new FHA base limit. This means that additional states will likely fall within this higher limit. This further means that, in many low- and moderate-priced areas of the country, the additional homes insured under the higher FHA base limit would only be affordable to borrowers with the highest incomes in the area. These are the borrowers who can afford homes priced well above the entire State's median priced house. These borrowers are unlikely to be first-time, moderate-income, or minority ones. A recent study by the Brookings Institution notes that counties with higher mean incomes also had higher home ownership rates, while counties with lower incomes had lower ownership rates.[33]
- Raising the FHA base limits thus means that FHA could become over-exposed to risk in entire states and MSAs. With this concentrated risk position, FHA would take on heightened risk in periods of economic stress. If this over-exposure were done to serve moderate-income first-time home buyers, then it might be justified. However, this would not be the case because higher FHA base limits would serve only those borrowers who can afford the highest priced homes in their area.

Targeting Higher-Income Borrowers Will Add to FHA Risk

- It is commonly assumed that borrowers with higher incomes are safer credits than low- and moderate-income borrowers. Evidence from the private mortgage insurance industry shows that this is not the case for low-downpayment borrowers during periods of regional economic stress and falling home prices.[34] It is one thing to have a relatively high income and owe a large mortgage on a home with equity of 20 percent or more. It is quite another issue to have a large mortgage with very little or no equity at all in the house during a period of falling house values. When borrowers start the ownership process with little or no downpayment, using an FHA-insured mortgage loan, they are extremely dependent on a continuing advance in home prices to build their equity. Any reversal in personal fortunes will find them underwater on their mortgage—owing more than the house is worth after real estate brokerage and other fees have been paid. This is especially the case for zero downpayment mortgages.
- The nature of the residential real estate market in the past decade has been very good to most risk-takers. Home prices have appreciated across the board—although with wide geographic variations. Unfortunately, there is no assurance that rapid house price appreciation will continue and signs of weakening home prices have already begun to materialize in certain areas of the country. Furthermore, past experience with regional downturns in house prices has shown that houses at the upper end of the price distribution are likely to suffer more serious declines in property values than more moderately priced houses.[35] This is not surprising. By definition, there are fewer people with the wherewithal to purchase higher-priced homes than those able to purchase more moderately priced homes. During a period of economic stress and falling home prices, the lack of liquidity at the higher end of the house price market will hurt these borrowers.[36] Since FHA insures 100 percent of the loan amount, the FHA stands to lose a great deal in this situation.

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[32] See generally, National Association of Realtors Median Sales Price of Existing Single-Family Homes for Metropolitan Areas available on NAR web site.

[33] *Credit Scores, Reports, and Getting Ahead in America*, May 2006, The Brookings Institution, Survey Series, Matt Fellowes, see p. 1.

[34] For evidence of loan performance during stress periods see testimony of Charles Reid, President of the Mortgage Insurance Companies of America, before the Subcommittee in Housing and Community Development, on FHA's Mutual Mortgage Insurance Fund, July 27, 1993, Attachment A, Incremental Risk of Higher Mortgage Amounts, 1981–1989.

[35] There are already some early signs of declining prices for higher priced houses. See for example, the Wall Street Journal for Friday, June 16, 2006.

[36] In this regard it is interesting to note that the FHA loan limits that existed in the late 1980s and early 1990s may well have protected the MMI Fund from the severe losses that were incurred in the private sector by the house price declines in New England and Southern California during these years.

- The potential loss for FHA from raising its loan limits will be significant during a period of falling regional house prices. A 30 percent loss on a foreclosed $100,000 FHA-insured loan costs the single-family Fund $30,000. A 30 percent loss on a $271,000 loan costs the Fund $81,000 and a similar loss on a $417,000 loan would cost the Fund $125,000. If, as is the case in the private sector, larger FHA loan amounts that go to foreclosure during periods of severe economic stress suffer larger percentage reductions in value, then the Fund would suffer still greater, unanticipated losses.
- New moderate-income borrowers seeking to qualify for an FHA loan during this period of economic stress will feel the impact of these losses to the Fund. Just as new borrowers paid the higher FHA loan premiums needed to return the single-family Fund to economic solvency in the early 1990s, so too will future moderate-income borrowers bear the higher costs associated with the losses resulting from defaults on larger loans. Will there be a regional house price decline resulting in heavy losses to FHA? We don't know. However, we do know that low- and moderate-income borrowers gain nothing and may well lose from retargeting FHA to higher-income borrowers because FHA would suffer larger losses than would otherwise have been the case.

A Risky Proposition: A Risk-Based FHA Insurance Premium

FHA proposes to change its premium structure from one relying on cross subsidization to a risk-based structure. This will be a significant change from FHA's current premium structure and poses new risks on FHA and its traditional borrowers.

The Present Premium Structure

- The present FHA premium allows FHA to charge a fully financed upfront premium of as high as 2.25 percent and an annual premium of as high as 50 basis points for loans with initial LTVs of 95 percent or less and 55 basis points for loans with initial LTVs above 95 percent. The upfront premium does not count as part of the borrower's loan-to-value (LTV) calculation for purposes of the annual premium calculation. Currently, HUD charges a 1.5 percent upfront premium and 50 basis points annual premium for all loans. FHA has also implemented a mortgage cancellation program whereby the insurance premium payments are canceled for the borrower when the LTV reaches 78 percent (5 years of payments required). Although the borrower no longer must pay the premium, FHA continues to insure the loan.
- Cross subsidization is the key to this system. Borrowers with the same downpayment pay the same premium regardless of different credit characteristics—provided they cross a minimum credit hurdle. This is a key reason why FHA has had such a large share of minority and low-income borrowers and why it continues to serve this market. As the Brookings Institution report notes, the borrower with a poor credit rating often has comparatively lower income.[37] These are the borrowers who benefit under cross subsidization.

Low-Income and Minority FHA Borrowers Are Likely to Pay More

- The Brookings Institution study concluded that low-income and minority borrowers are often the ones with the lower credit scores. Specifically the report found that "counties with relatively high proportions of racial and ethnic minorities are more likely to have lower average credit scores."[38] The report noted that "this evidence does not suggest that a bias exists, or that there is a causal relationship between race and credit scores, raising questions for future research."[39] With respect to income distribution, the report found that "[t]he average county with a low, mean credit score had a per capita income of $26,636 and a home ownership rate of 63 percent in 2000. Meanwhile, the typical county with high-average credit scores had higher per capita incomes ($40,941) and a higher share of homeowners (73 percent)."[40] If FHA is seeking to lower the premium price for higher credit score borrowers and raise the premiums for lower scored borrowers, then higher-income borrowers in areas where home ownership is already high would benefit.
- FHA staff harbor concerns about using credit scores to set premium prices. The November 2005 report from the HUD IG mentioned above notes, "[m]anagement has indicated some sensitivity to focusing solely on credit scores

[37] Brookings, *Op. Cit.,* p. 1.
[38] *Ibid.,* p. 8.
[39] *Ibid.,* p. 1
[40] *Ibid.* See also p. 10.

because of the risk of discouraging lenders from underwriting loans to some of FHA's target borrowers who may have low credit scores."[41]

- The Congressional Budget office also suggest that FHA will get few if any net new borrowers as a result of a risk-based premium. In its analysis of the FHA reform bill, H.R. 5121, released on June 14, 2006 it sees no net increase in the number of FHA loans guaranteed through a risk-based premium because "while some borrowers may turn to FHA because of better pricing and the ability to obtain insurance for more attractive loan products, other borrowers may turn away from FHA because of higher pricing."[42] Those other borrowers who would turn away from FHA are likely to be those who FHA perceives to be weaker credit risks.

FHA Could Well Get a Risk-Based Premium Wrong

The HUD IG report, the MMI Actuarial study and GAO reports all conclude that FHA does not have adequate data to correctly evaluate the credit risk associated with its borrowers.

- The HUD IG notes that, "[w]ithout adequate data on borrower credit scores, FHA is unable to determine whether . . . declining borrower credit scores have contributed to significant unexpected upward re-estimates of its insured loan guarantee liability in recent years."[43]
- CBO in its analysis of the FHA reform bill, H.R. 5121, notes that risk-based pricing is "complicated, requiring much precision in the underwriting process."[44] CBO also references the GAO report on the TOTAL scorecard noted above, which raised concerns about the effectiveness of the underwriting system that exists today and recommends improvements. As a result of FHA's current systems inadequacies, CBO expects that developing and maintaining appropriate systems for managing a risk-based pricing structure would take FHA "several years to implement."[45] In short, CBO recognizes that a risk-based premium is a difficult process to effectively implement and requires sophisticated systems that FHA simply does not now have that would take years to develop.

Market Impact of a Risk-Based FHA Premium

- FHA does not operate in a market vacuum. A decision by FHA to set a risk-based premium will pressure its private sector alternatives to follow suit to remain attractive to those low-downpayment borrowers that are perceived to be lower risk under whatever risk-based premium structure FHA develops. Today's FHA and private premiums serve low-income and minority low-downpayment borrowers so that they too can take the first step of building equity in a home. However, a turn to a market-wide risk-based premium structure would undermine potential home ownership for this group.

Broad-Based Reform Recommendations

- The current system for setting FHA eligibility on loan size, rather than the income of the borrower, makes no sense for a government insurance program. A government program must focus on the people it serves and this is best determined by looking at them, not abstract indicators, proxies, or substitute factors.
- It is time that FHA became an income-targeted—rather than a loan amount targeted—housing program. The current system for setting FHA area loan limits is skewed toward raising these limits above the true median house price for an area, never lowering them, even if house prices fall. Income targeting FHA's single-family program will assure that low- and moderate-income borrowers become the primary focus of the program. It should also make housing more affordable for these targeted borrowers.
- Income targeting would also be simple to implement. Borrowers would bring to the lender their most recent tax returns (as they currently do) and, if their income was within the parameters for their area, then they could qualify for an FHA-insured loan. Their loan size would depend on their income and interest rates—much as it does now. Incentives for sellers to raise their prices as area loan limits are increased would end.

[41] HUD IG Report, *Op. Cit.,* Appendix A, p.7.
[42] CBO Report, *Op. Cit.,* p. 7.
[43] HUD IG Report, *Op. Cit.,* Appendix A p. 7
[44] CBO *Op. Cit.,* p. 7.
[45] *Ibid.*

- The 100 percent Federal guarantee behind FHA insurance undercuts the financial health of the MMI Fund, provides incentives for lax underwriting, and is not needed to make FHA insurance useful for most of its target borrowers.
- A logical approach would be to set a maximum FHA coverage ratio and have it apply only to the lowest income borrowers. As the income of the borrower increases, the level of the FHA insurance coverage would fall. In this way, the protection of Federal insurance coverage would go to lenders making loans to lower-income borrowers. Further, linking insurance coverage to income in this way creates a positive incentive for the market to serve these borrowers.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM WILLIAM B. SHEAR

Q.1. What are the most critical problems that FHA needs to address if it is to carry out the proposed changes? How long would you expect it to take to make these changes?

A.1. To successfully implement the proposed program changes, including risk-based pricing and lower downpayment requirements, FHA will need to improve its ability to assess and manage risk. In particular, FHA will need to address limitations with its TOTAL scorecard and be more open to adopting the risk management practices of other mortgage institutions. Although FHA's overall approach to developing TOTAL was reasonable, the data FHA used to develop TOTAL were 12 years old by the time that the agency began using the scorecard. Therefore, the data may not reflect recent changes in the mortgage market affecting the relationship between loan performance and borrower and loan characteristics. Without regular updates, TOTAL may become less reliable for assessing credit risk and, therefore, less useful for implementing risk-based pricing and developing new mortgage products. Some of the practices of other mortgage institutions offer a framework that could help FHA manage the risks associated with new mortgage products such as no-downpayment mortgages. These practices include piloting and requiring stricter underwriting on these products. Although piloting products requires an investment of resources, the potential costs of making widely available a product whose risk is not well understood could exceed the cost of implementing such a product on a limited basis.

The amount of time FHA will need to address TOTAL's limitations and develop pilot programs for new products is uncertain but will depend on the commitment of FHA management and the availability of resources necessary to implement these changes. FHA has a contract to update TOTAL by 2007; however, it is unclear whether the update will address all of the concerns we have raised with the scorecard or how long it will take FHA to field an updated version of TOTAL once the contractor has completed its work. It is also unclear how long it would take FHA to develop pilot programs for new mortgage products. FHA officials have said that they lacked sufficient resources to appropriately manage pilot programs, a factor that could prevent the agency's use of pilots in the near term.

Q.2. Based on your knowledge of FHA's current operations, are there alternative ways to reorganize FHA that would allow it to better compete and to better serve low-income households?

A.2. We have not studied options for reorganizing FHA nor have we evaluated why the agency is now serving fewer borrowers in its traditional segment of the mortgage market. However, we have identified a number of steps that the agency could take to help it succeed in a competitive marketplace. For example, we recommended that FHA explore additional uses for TOTAL, including applying the scorecard to proposed initiatives—such as risk-based pricing and the development of new products—which may help strengthen the FHA-insurance fund and reach additional borrowers. We also recommended that FHA improve TOTAL by devel-

oping policies for regularly updating the scorecard. This action may help FHA reduce its vulnerability to adverse selection that occurs when conventional mortgage providers approve lower-risk borrowers in FHA's traditional market segment, leaving relatively high-risk borrowers for FHA. Finally, we recommended that if Congress authorized FHA to insure mortgages with smaller or no downpayments, the agency adopt practices used by other mortgage institutions—such as piloting—that could help FHA to design and implement products with the potential to broaden the agency's customer base.

RESPONSE TO A WRITTEN QUESTION OF SENATOR REED FROM BASIL N. PETROU

Q.1. You have been a consultant to the Mortgage Insurance industry. If FHA's proposed changes are implemented, how will these changes affect the members of this industry and the way that they do business? Would you expect the use of risk-based pricing by the industry to expand?

A.1. As I noted in my testimony, the FHA does not operate in a market vacuum. In my opinion, a decision by FHA to set a risk-based premium will pressure its private sector alternatives to follow suit so as to remain attractive to those low-downpayment borrowers that are perceived to be lower risk under whatever risk-based premium structure FHA develops. Consequently, I would expect the use of risk-based premiums to expand beyond FHA into the borrower-paid private mortgage insurance market.

STATEMENT OF THE MORTGAGE INSURANCE COMPANIES OF AMERICA

JUNE 20, 2006

The Mortgage Insurance Companies of America (MICA), the trade association representing the mortgage insurance industry, is pleased to provide a statement for the hearing to take a comprehensive look at the Federal Housing Administration (FHA) and the reforms that are needed to improve its financial security and the overall operation. We hope you will find it helpful.

The FHA is the government alternative to private mortgage insurance. Like FHA, we insure mortgage loans when borrowers put down less than 20 percent. The mortgage insurance industry has been extremely successful in expanding home ownership opportunities for Americans. Since the industry was founded in 1957 it has helped almost 25 million people buy homes with low downpayments by protecting lenders against the risk of default. The mortgage insurance industry also has worked aggressively to target mortgage money to underserved families and has pioneered ways to better serve this market.

Mortgage insurers have insured almost $2.4 trillion in mortgages since the industry was founded. As a result of our experience we are in a unique position to evaluate the changes to the FHA program that the Administration is suggesting. Like FHA, mortgage insurers have their capital on the line in every loan that they insure. If the borrower defaults, then the borrower and insurer experience a loss. The insurer's job—whether a private or government insurer—is to strike a balance between putting as many families into homes of their own as possible and ensuring the loans do not go to default. Private mortgage insurers have been very successful in doing this and we hope our insight will help you as you consider ways to reform FHA.

We are very concerned with two of the changes to FHA being proposed by the Administration—the proposed risk-based premium and the increase in the base FHA loan limit. We believe that with the mortgage market softening, FHA's financial situation deteriorating, and FHA's lack of appropriate analytical tools this is the exact wrong time to institute these changes FHA is suggesting. Not only will they hurt the people FHA was established to serve but they will hurt FHA financially. In our

statement we will discuss FHA's financial condition, the proposals by the Administration to reform FHA, and offer other suggestions on how to reform FHA.

FHA's Financial Condition

There is a growing amount of evidence that not only is FHA's financial condition deteriorating but that it does not have the proper tools to evaluate risk. Discussed below are several studies showing that FHA has serious problems both with its model and with its ability to measure loan performance.

Actuarial Study

In 1990, FHA's Mutual Mortgage Insurance (MMI) Fund was losing about $1 million a day. Congress, working with the Administration, enacted the National Affordable Housing Act of 1990. That legislation instituted a number of changes to FHA which were designed to put it on the road to financial health. One of those changes was that it required FHA to do a yearly actuarial study.

The most recent actuarial study was released in early 2006 and was for fiscal year 2005. While on its face the study might seem to indicate that the MMI Fund was well capitalized—because it indicates the MMI Fund has a 6.2 percent capital ratio—that is only part of the story.

First of all, the actuarial study for fiscal year 2005 was not tactually a study for the entire fiscal year. It only covered loans for the first half of the fiscal year. The actuarial study notes that the reason it was not for the complete fiscal year was because loan data for the second half of the fiscal year was not available. No new actuarial data or study has been released so one can presume that FHA has no new data for almost the first three quarters of fiscal year 2006. As a result, FHA does not know what its capital position has been for almost the last five quarters.

Second, the primary reason the MMI Fund's capital ratio improved from the fiscal year 2004 level is because of a decrease in FHA's market share. This decrease took place at a time when the private sector was serving the mortgage market well and the country experienced very high home ownership rates.

Third, it is misleading to simply look at the capital ratio at a time when FHA's market share is declining because the capital ratio is the ratio between the MMI Fund's economic value and FHA's insurance in force.[1] The actual economic value fell by $2.8 billion, an 11 percent reduction in the value from the previous year.

Finally, the actuarial study notes an alarming new trending FHA. Loans to people whose downpayments were from someone other than relatives comprise 18 percent of FHA's new business and the losses on those loans reduced the MMI Fund's economic value by $1.7 billion. A subsequent November 2005 study by the General Accounting Office reported that FHA's share of these types of loans was actually 30 percent. While the Internal Revenue Service has questioned the true charitable nature of some of these charitable downpayment entities and some of them may be expected to close down in the near future as their tax exempt status is revoked, the poor performance of the existing loans will prove to be a continuing problem for FHA.

HUD Inspector General Report

A November 2005 HUD Inspector General (IG) report sheds more light on the inadequacy of the actuarial study FHA is using to predict losses. The IG report concluded that FHA does not have enough historical data on the various risk factors of its own borrowers to effectively evaluate loan performance. The IG report noted as a material weakness that "FHA must incorporate better risk factors and monitoring tools into its single-family insured mortgage program risk analysis and liability estimation process." Specifically, it found that FHA lacks a formal process to effectively evaluate the impact on the MMI Fund of loan factors, "such as borrower credit scores, downpayment assistance sources, and other portfolio characteristics."

Finally, and perhaps of more immediate concern, the HUD IG concluded that "FHA also cannot determine current risk trends in its active insured mortgage portfolio." That is, FHA is not sure what is driving the current surge in its claims. As a critical example of this failure, the HUD IG notes that the MMI Fund's independent actuary determined that the claim rates for loans where the borrowers received non-relative assistance for the initial loan downpayment was "as high as

[1] For purposes of FHA's actuarial report the economic value of the MMI Fund is calculated as Total Capital Resources plus the present value of future cash-flows accruing to the MMI Fund. Total Capital Resources is defined as the sum of total assets (cash, investments, properties and mortgages, and other assets and receivables) less liabilities and with the addition of net gains from investments and net insurance income. FHA's capital ratio increased for the first half of fiscal year 2005 only because the insurance in force denominator of the ratio fell more sharply than its economic value.

three times those that did not receive assistance.” However, the report concludes that “FHA has not had sufficient data to segregate these loans into a separate risk category for loss estimation purposes.”

GAO Study

The General Accountability Office (GAO) in a study dated April 2006 pointed out another technological problem, which makes FHA ill-equipped to enter risky new ventures. Like the two studies discussed above, the GAO study again illustrates that FHA needs to spend time gathering data and developing systems.

GAO studied the Technology Open to Approved Lenders (TOTAL) scorecard, an automated underwriting system developed by HUD from 1998–2004. The scorecard is not a credit model but rather, as GAO notes, a vehicle whereby certain credit factors are input by the loan originator and, if a certain score is attained, the loan is determined to be eligible for FHA insurance. If the necessary score is not attained, the loan will require manual underwriting to determine suitability.

Since 2004, FHA and its lenders have used TOTAL to evaluate applications for FHA-insured loans and inform underwriting criteria used in approving loans. In its study, GAO suggested that this system could be used to do risk-based pricing. In addition, HUD in a March 31, 2006 letter to GAO included in the report notes that while TOTAL was not intended for risk-based pricing that FHA “is exploring how it might be used for that purpose,” but that “this could be a lengthy exercise with an unknown outcome . . . ” and that if FHA is given authority by Congress for new products, FHA “will certainly explore the benefits that TOTAL may present in developing such products.”

The GAO study provided reasons why TOTAL in its present form is not up to the task of being used to risk base price FHA loans. Some of the reasons include, first, the data used in the system is 12 years old, which severely limits its effectiveness because the market has changed so significantly. Importantly, FHA has not developed a formal plan to update the data on a regular basis. Second, FHA did not develop important variables such as type of loan instrument (adjustable rate or fixed-rate loan) and type of home (condominium or single-family home) that are vital to explaining expected loan performance. Third, FHA only used data from loans it had agreed to insure and did not include data from loans it rejected. As GAO points out, this will impair the ability of TOTAL to evaluate people with poorer credit scores and could mean that a higher percentage of loans that are likely to default would be accepted rather than referred to manual underwriting.

In its written response to the GAO study HUD took issue with some of these criticisms or indicated that TOTAL’s effectiveness is being reassessed. However, we do not know if FHA has brought TOTAL up to the standards needed to properly evaluate risk.

FY 2007 Budget

The fiscal year 2007 budget discusses the fundamental problems that remain with FHA’s analytical techniques and brings into question FHA’s ability to enter new, risky areas. First the budget notes that FHA does not have the technical ability to accurately assess risk. Specifically, it says “ . . . the program’s credit model does not accurately predict losses to the insurance fund.” A credit model is an integral part of an actuarial analysis and a flawed credit model will generate flawed actuarial results.

The fiscal year 2007 budget document then goes on to discuss and provide data on the effect of not having a credit model that predicts losses. For the first time the fiscal year 2007 budget document reports that FHA had to re-estimate the value of the loans in the MMI Fund. Each book of loans put in the MMI Fund from 1996 through 2005—effectively all loans still in the MMI Fund—were re-estimated to show a reduction in their value compared to the original estimate that had been sent to Congress. The reductions were significant. The most recent books of business—the ones since fiscal year 2000, which comprise the bulk of the MMI Fund—showed reductions of more than 50 percent in their value to the MMI Fund. As a consequence, whereas the MMI Fund had been estimated last year to generate a budget benefit (referred in the budget as a net negative subsidy rate) of 1.8 percent, the re-estimates resulted in the MMI Fund only just breaking even for fiscal year 2007. Any worsening in the MMI Fund performance will result in the FHA program costing the government money in budgetary terms.

Finally, the fiscal year 2007 budget documents note another recurring problem with FHA—fraud. The budget says that “despite FHA efforts to deter fraud in the program, it has not demonstrated that these steps have reduced such fraud.” FHA needs to remedy this problem before it expands into riskier programs it has not previously done.

Industry Data

Industry data also illustrates FHA's financial problems. Recent data on delinquencies from the Mortgage Bankers Association for the fourth quarter of 2005 shows that FHA loans have a 13.18 percent total delinquency rate, while prime conventional loans have a 2.47 percent delinquency rate. Looking only at fixed-rate mortgages the FHA total delinquency rate was 12.02 percent versus 2.21 percent for prime loans. Total delinquency rate for all subprime loans was 11.63 percent and total delinquency rates for subprime fixed-rate mortgages was 9.7 percent. Given the fact that FHA does not have the technical ability to adequately predict losses, is just breaking even, and has substantially worse default rates than the prime conventional market, it should not attempt to enter a new and very risky area of risk-based premiums. If new loans are not priced correctly FHA will simply suffer more losses.

Housing Market is Beginning to Soften

This is the wrong time for FHA to be instituting some of the changes it is suggesting because the housing market is softening. Many academic and industry professionals have written that the housing market has entered a new cycle—not a market crash, but just a slow down in the rate of future house price appreciation in certain regions of the country. In other words, in many regions of the country, overall home prices are either remaining steady or declining, but they are not increasing. Declining values will dramatically increase foreclosures on all categories of loans and particularly on loans with low or no downpayments.

Rapidly rising house prices can—and undoubtedly have in recent years—bailed out some bad FHA mortgage decisions. As long as the house can be sold for more money than it cost most people will avoid foreclosure and simply sell. However, when prices stop rising the FHA borrower, Ginnie Mae and FHA are left with the consequences of any bad underwriting decisions. Therefore, it is questionable whether FHA should now be seeking to expand its market presence and engage in risky activities such as risk-based premiums when the mortgage markets may just be turning to their down cycle.

Proposed Changes to FHA

The Administration proposes some key changes to FHA which MICA believes will hurt it financially and will push it away from the people it was intended to serve. We will focus on two proposals—the proposals to change FHA's premium to a risk-based premium and to raise FHA's base loan limits.

The Pitfalls of Risk-Based Pricing

FHA proposes to change FHA's premium structure from one that relies on the concept of spreading the risk (often referred to as cross subsidization) to one using a risk-based premium structure where each individual loan is priced separately. Risk-based premiums will be detrimental in two ways. First, they will hurt FHA's core constituency—low- and moderate-income people—because they will end up paying more for their FHA loan. Second, as noted above, FHA does not have the analytical capability or the financial soundness to suddenly start to risk-base prices in a softening mortgage market. These points are discussed in more detail below.

Present Structure Works—The present FHA premium was also part of the 1990 reforms to FHA mentioned above. In the law, Congress authorized the Secretary of HUD to charge borrowers an initial upfront premium as high as 2.25 percent at closing and then an annual premium. The upfront premium can be fully financed as part of the mortgage and does not count as part of the borrower's loan-to-value (LTV) calculation. The annual premium is a cash payment paid on a monthly basis. It was set at 50 basis points for loans with initial LTVs below than 95 percent and 55 basis points for loans with initial LTVs at or above 95 percent. In addition, the lower the amount of the downpayment the longer the borrower would have to pay the monthly premium. Since 1990, HUD has chosen to reduce its upfront premium for first some, and then all, FHA borrowers. Similarly, HUD has chosen not to implement a higher annual premium for borrowers with initial LTV ratios at or above 95 percent. Additionally, FHA has implemented a mortgage insurance cancellation policy whereby for mortgages with terms of more than 15 years the annual mortgage premium will be canceled when the LTV reaches 78 percent provided the mortgagor has paid an annual premium for at least 5 years.

The key to this system is spreading the risk because a person putting down for example, 3 percent, and a second person putting down the same amount pay the same premium even if the second person has a few blemishes on their credit report. As the discussion on the Brookings Institute data below suggests, the person with the blemished credit rating is often lower income. Under FHA's existing premium

structure low downpayment mortgages are affordable for everyone because the risk is spread among all borrowers with the same amount of downpayment.

This system also works on a nationwide basis because no one knows when or where a sharp reduction in regional house prices will occur. The MMI Fund, therefore, needs geographic distribution to support future regional downturns. The MMI Fund needs people in a part of the country with stable house prices and their premium incomes to protect the fund against regional house price downturns.

A major rationale given for the FHA entering into risk-based pricing is that it would become able to insure subprime loans currently being originated in the private market. The higher risk-based mortgage insurance rates proposed for subprime loans supposedly would enable the FHA to profitably insure such business. However, given that current FHA business has even higher delinquency rates than the subprime market, both for total business as well as fixed-rate business, one could conclude that the higher rates proposed for new subprime market loans would also apply to much of future FHA business with characteristics similar to business originated today at current lower, non-risk-based rates. Therefore, risk-based pricing very probably will lead to effectively higher rates for a very large proportion of the current FHA market. Such an effect may seriously impact the FHA's mission to offer affordable loans to its current clientele.

Lower Income and Minority Borrowers will be Hurt—Proposals to allow FHA to risk base price means that risk spreading will no longer exist in the FHA program. Instead, the basis for the premium apparently will be to a great extent based on credit scores. The higher the credit score, the lower the premium, and the lower the credit score the higher the premium. A recent Brookings study concluded that low-income and minority borrowers are often the ones with the lower credit scores. Specifically the report found that "counties with relatively high proportions of racial and ethnic minorities are more likely to have lower average credit scores." The report noted that "this evidence does not suggest that a bias exists, or that there is a causal relationship between race and credit scores, raising questions for future research." With respect to income distribution the report found that "[t]he average county with a low, mean credit score had a per capita income of $26,636 and a home ownership rate of 63 percent in 2000. Meanwhile, the typical county with high average credit scores had higher per capita incomes ($40,941) and a higher share of homeowners(73 percent)."

Importantly, the November 2005 report from the HUD IG mentioned above discussed HUD's reluctance to use credit scores in pricing loans. The report says, "[m]anagement has indicated some sensitivity to focusing solely on credit scores because of the risk of discouraging lenders from underwriting loans to some of FHA's target borrowers who may have low credit scores." [Appendix A, page 7] The report goes on to talk about an issue discussed above and that is FHA's inability to properly underwrite based on credit scores because FHA does not have adequate data to properly evaluate borrowers. The report says, "[w]ithout adequate data on borrower credit scores, FHA is unable to determine whether . . . declining borrower credit scores have contributed to significant unexpected upward re-estimates of its insured loan guarantee liability in recent years." This fact alone raises serious questions as to whether FHA has the historical data needed to include credit scores as an effective risk factor in setting a new premium structure.

Borrowers are hurt by FHA's inability to control losses. FHA's claim rates represent families who have gone through the personal and financial tragedy of foreclosure. FHA should be in the forefront of eliminating predatory lending and MICA applauds FHA's desire to do so. However, careful underwriting of FHA loans, thereby reducing the number of foreclosures in the FHA program, is an important first step in doing this. As the bank regulators have noted, a predatory loan encompasses one that is based without regard to the borrower's ability to repay the loan according to its terms. Careful underwriting becomes even more important as FHA reduces the downpayment requirements, lowers credit underwriting standards and otherwise modifies its underwriting to extend its operations into the subprime arena.

As noted above, claim rates on certain parts of FHA's current book of business are exceedingly high, as evidenced by the total delinquency rates for the FHA single-family program. Before FHA expands deep into the subprime market it is important that it determine what went wrong in the underwriting of its existing loans that proved to have high claim rates. FHA should not repeat these same underwriting problems as it expands into other markets.

FHA Lacks Analytical Capabilities—The first section of this statement discusses in detail the various studies and reports that demonstrate FHA does not have the analytical ability to risk-base price. This analytical ability is the key to FHA's financial health.

A mortgage insurer has two essential tools to determine the best way to serve the market for low downpayment mortgages and maintain its financial health—underwriting the loan and setting the premiums at the level to match the risk. If a premium is set at a very high level the underwriting criteria could be very liberal and, therefore, allow many borrowers to get mortgage loans. However, the premium is likely to be so high that many borrowers could not afford the loan. Conversely, if the underwriting is so strict that the premium is very low, while many borrowers might be able to afford the loan, they might not meet the underwriting criteria. The key to enabling a large number of borrowers to buy homes with low downpayments is to balance the underwriting criteria with the premium.

FHA needs to work on developing its analytical systems so that it can understand the risk to the MMI Fund of the loans it is insuring and properly manage that risk through appropriate underwriting and premium levels. The present premium parameters set by the National Affordable Housing Act of 1990 give FHA flexibility to adjust premium levels to manage the risk of loans with varying downpayments, yet maintain the system of risk spreading that ensures a large pool of borrowers can afford FHA-insured loans. FHA simply is not ready to jump into the world of risk-based pricing where premium are set on a loan-by-loan basis.

Note that the Congressional Budget Office (CBO) in its analysis of the FHA Reform bill, H.R. 5121, released on June 14, 2006, agrees that FHA does not have the systems in place to begin risk-based pricing. CBO notes risk-based pricing is "complicated, requiring much precision in the underwriting process." CBO references the GAO report on the TOTAL scorecard noted above, which raised concerns about the effectiveness of the underwriting system that exists today and recommends improvements. As a result of FHA's current systems inadequacies, CBO expects that developing and maintaining appropriate systems for managing a risk-based pricing structure would take FHA several years to implement.

FHA's Base Loan Limit Should Not Be Raised

FHA also proposes to raise the amount of the loans it can insure in areas with moderate house prices from 48 percent to 65 percent of the Fannie Mae/Freddie Mac loan limit. When considering whether to increase the FHA base loan limit it is important to remember exactly why the FHA base limit exists. It currently covers those areas where 95 percent of the area median house price is less than 48 percent of the Fannie/Freddie nationwide loan limit. In other words, in areas where the median house price is, for example, $140,000, FHA will insure a mortgage as large as $200,000. To put this into its proper context, each year the Fannie/Freddie nationwide loan limit is set looking at house sales across the country—in both high-cost and low-cost areas. The limit is determined looking at transactions where borrowers made low downpayments and high downpayments and at transactions which reflect first-time home buyers getting their starter homes and move-up buyers using equity from their previous homes to purchase relatively costly homes.

We believe that policymakers should ask "are all of these buyers the ones meant to be served by FHA?" Certainly, the composition of the current FHA user does not reflect all of these types of home buyers, and it should not. The latest FHA information for the week of May 1 through May 15, 2006 (available on the FHA web site) notes that 79.3 percent of the loans FHA insured were for first-time home buyers and 29.2 percent of these were minority households. These are the type of borrowers that have come to be associated with FHA as a government program and these are the type of borrowers who may well need a Federal Government guarantee. The existing FHA loan limits help assure that these are borrowers whom lenders direct to FHA.

The issue then to consider is whether these first-time and minority home buyers will still be served by FHA in low-cost areas if the base limit is raised. FHA's proposal would increase this amount to $271,000. This means in many low- and moderate-priced areas of the country FHA will essentially be insuring houses that are only affordable to borrowers with the highest incomes in the area. For example, the median existing house price in Binghamton, New York, South Bend, Indiana, and Yakima, Washington, are all reported at below $100,000 according to a report from the National Association of Realtors (NAR). The current FHA base limit of $200,160 applies in all these areas and is double the existing house price. Raising the FHA base limit to 65 percent of the GSE loan limit would move the FHA limit for these areas to $271,000 or almost three times their median existing house price. Areas affected are not necessarily small towns. For example, the NAR calculates that the median existing house price in the Dallas, Texas-Fort Worth-Arlington MSA is now $148,000 and the current FHA base limit applies to this MSA. Raising the base limit to $271,000 would take it to almost twice the median existing house price in this large MSA.

Borrowers getting FHA mortgages with the new base limit are not likely to be first-time home buyers, moderate-income buyers, or minority buyers. The Brookings study on credit scores mentioned above notes that counties with higher mean incomes also had higher home ownership rates while counties with lower incomes had lower ownership rates.

Raising the FHA base limits also means that FHA will be unnecessarily insuring a larger share of the homes in these moderate cost areas so that it will be overexposed to economic downturns in these regions. If this over-exposure was being done to serve moderate-income first-time home buyers then, perhaps, it might be justified. However, by definition this will not be the case. It will be to serve only those borrowers who can afford the higher priced homes in their area. And combined with risk-based pricing, it may be done to the detriment of the traditional FHA borrower.

MICA's Suggested Reforms to FHA

In order to effectively "modernize" FHA, MICA believes it has to get back to the basics. In other words, it has to take some elementary, but vital steps to be able to understand and manage the risk it is insuring. Without the fundamental ability to understand and manage its risk, FHA's financial condition will so deteriorate that it could end up costing the taxpayers money. The following are MICA's suggested reforms to FHA:

1. FHA should develop modern systems that allow it to analyze the data it currently has available on its existing portfolio of insured mortgages and their performance. It is imperative that FHA follow up on the HUD IG request that it determine what factors are driving the current surge in its claims.
2. FHA should comply with GAO and HUD IG recommendations on improving the accuracy of its credit models. Both severity and frequency of claims should be assessed by loan type and borrower credit characteristics.
3. Underlying problems with the performance of downpayment assistance loans must be assessed and corrected. Downpayment assistance can be an important part of serving the needs of low- and moderate-income groups. An explanation is required for why the problems arose in the first place. The underwriting of these loans should be thoroughly analyzed to assure that the same mistake is not made again for new FHA-insured loans.
4. A system must be developed to update the TOTAL scorecard to reflect access to timely data.
5. Once Congress is satisfied that FHA's analytical capabilities are up to par with the private sector, GAO should study the feasibility of FHA engaging in risk-based pricing. GAO should initially determine whether risk-based pricing is necessary for FHA to serve its core constituency—lower-income and minority borrowers—or whether the existing premium structure which depends on the amount of downpayment and utilizes the concept of risk spreading enables FHA to help these people buy homes while properly managing risk. Part of analyzing this initial question should include whether FHA is utilizing all the premium options available to it under the National Affordable Housing Act of 1990. As noted above, current law allows FHA to charge higher premiums based on the amount of downpayment. It should also include an analysis of whether risk-based premiums will actually result in higher-priced loans for FHA's core constituency than the existing premium structure. If GAO determines that the present premium is a failure, it should make recommendations on the factors FHA should put into a risk-based premium.

MICA recognizes that implementing these suggestions will require very skilled outside resources which will be expensive. However, developing these analytical tools should be its top priority to assure that the program can continue to operate as a budget benefit while providing assistance to first-time and low- and moderate-income home buyers. Spending FHA funds on secondary efforts should be postponed until such time as FHA has a better grasp on how to manage the key risks that exist in its portfolio of insured loans.

We hope the members of the Committee have found this statement helpful.

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

JUNE 20, 2006

The Importance of the Federal Housing Administration

The National Association of Home Builders (NAHB) and its 225,000 member firms have long been steadfast supporters of the Federal Housing Administration (FHA). Since it was created in 1934, and for much of its existence, FHA has been viewed as a housing finance innovator by insuring millions of mortgage loans that have made it possible for home buyers to achieve home ownership. Without FHA, many of these buyers would have had to delay their purchase, been unable to purchase a home, or would have done so at an unnecessarily high cost.

FHA matters for a lot of reasons, not the least of which is that throughout its more than 70-year history, FHA's single-family mortgage insurance programs have served home buyers in all parts of the country during all types of economic conditions. Moreover, FHA has done this without any cost to America's taxpayers.

FHA's Growing Irrelevancy

Over the past two decades, the popularity and relevance of FHA's single-family mortgage insurance programs have waned as FHA's programs have failed to keep pace with competing conventional mortgage loan programs. In many respects, this is due to statutory and regulatory constraints that have limited FHA's ability to respond to the needs of borrowers who might have otherwise chosen FHA.

All too often, the differences between FHA's requirements and those for conventional mortgages have been viewed by lenders, appraisers and others as a disincentive to use FHA programs. Likewise, FHA's unique and often burdensome requirements have caused many home builders to avoid using FHA's programs to build homes—including condominiums—that otherwise would have been well-suited to borrowers who planned to use FHA-insured mortgage loans.

Furthermore, FHA's lack of responsiveness to market needs has created opportunities for predatory lenders to charge unreasonably high fees and interest rates to borrowers who, despite limited cash resources and/or tarnished credit, could have qualified for market-rate FHA-insured loans.

The recent decline in FHA mortgage insurance activity, both in real terms and when measured against conventional loan programs, is bothersome in other respects as well. For example, FHA-insured loans serve as collateral for mortgage-backed securities issued by the Government National Mortgage Association (Ginnie Mae), which, like the FHA, is part of the U.S. Department of Housing and Urban Development (HUD).

Ginnie Mae serves a vital role in America's housing finance system by providing liquidity for lenders to offer mortgages that are insured or guaranteed by FHA and other government agencies. Because the bulk of Ginnie Mae securities are backed by FHA-insured loans, the declining trend in FHA-insured loan originations, if unabated, could call into question the viability of the Ginnie Mae program.

FHA's Revitalization Bodes Well for Its Future

Important strides have been made to revitalize FHA under the leadership of Assistant Secretary for Housing/FHA Commissioner Brian Montgomery with the support of HUD Secretary Alphonso Jackson. NAHB was gratified to learn that, upon taking office in June 2005, Commissioner Montgomery challenged his staff to identify obstacles that stood in the way of more widespread use of FHA's single-family programs. The Commissioner, furthermore, charged his staff with the task of finding ways to overcome those obstacles.

The benefits of Commissioner Montgomery's efforts are already being realized as FHA has aligned its appraisal requirements with market practices by eliminating some bothersome paperwork requirements that needlessly created extra work for lenders, appraisers and home builders simply because a home buyer chose to use an FHA-insured loan to finance the purchase of a home. Other steps that have made the program more user-friendly are FHA's new policies that increase the allowable loan-to-value (LTV) ratio for cash-out refinancing transactions and revisions to the 203(k) rehabilitation program.

Congress Should Quickly Act To Empower FHA

Despite these positive moves, FHA's loan limit structure, downpayment requirements, and mortgage insurance premium scales, which are established by Congress, seriously constrain FHA's ability to deliver the range of mortgage products that are needed for FHA to fulfill its mission. FHA has proven through the years that it can serve some of the riskiest segments of the borrowing population, and do so in an actuarially sound manner.

The *Expanding American Home Ownership Act of 2006* (H.R. 5121), which incorporates many significant concepts that were articulated in the Administration's fiscal year 2007 budget proposal, has received broad bipartisan support among members of the House Financial Services Committee and has been voted out of Committee for consideration by the full House. NAHB believes strongly that H.R. 5121 would increase FHA's flexibility to mold its mortgage-insurance programs in ways that meet the borrowing needs of unserved, underserved, and improperly served families and others who desire to purchase a home. These are people who, for a variety of reasons, either cannot get a mortgage loan or who needlessly pay extraordinarily high costs for mortgage credit.

Mortgage Limits

The limit for FHA-insured mortgages is established in statute as 95 percent of the median home price of an area, within the bounds of a national ceiling and floor. FHA's single-family loan limit for the 48 contiguous states is currently capped at $362,790, which is 87 percent of the Fannie Mae/Freddie Mac conforming loan limit. This limit is too low to enable deserving potential home buyers to purchase a home in many high-cost areas. Likewise, the FHA "floor" of $200,160, which is indexed at 48 percent of the conforming loan limit, sets and unrealistically low boundary in many of the markets in which it applies.

The artificially low FHA loan limits restrict choices for home buyers who use FHA-insured mortgage loans to the lowest echelon of available homes throughout much of the country. In many areas, FHA borrowers are precluded from considering the purchase of a new or recently constructed home. NAHB does not believe that Congress created the FHA in 1934 with the intent of constraining borrowers to homes priced at the absolute lower end of the market. NAHB supports the Administration's proposals to recalibrate local loan limits to 100 percent of the area median from the current 95 percent and to increase the national ceiling and floor for FHA loan limits to 100 percent and 65 percent, respectively, of the conforming loan limit.

Downpayments

One of the most common factors preventing potential home buyers from achieving their dream of home ownership is the lack of financial resources to pay the downpayment and closing costs. FHA's current statutory requirement for a cash contribution of 3 percent by a home buyer was innovative when downpayments of 10 percent or more were the norm for conventional loans. Recent strides in credit modeling, such as FHA's TOTAL Mortgage Scorecard, have made it possible to predict with a reasonable certainty the likelihood that a borrower will default on their loan and, therefore, have rendered the downpayment a less critical variable in the underwriting process.

NAHB believes that Congress should grant FHA the flexibility to eliminate downpayment requirements for its single-family programs as long as the programs are operated on an actuarially sound basis. NAHB also believes it is important for FHA to have the flexibility to establish other reduced-downpayment mortgage options to more fully address market needs.

Mortgage-Insurance Premiums

Likewise, NAHB believes FHA should have the authority to set mortgage insurance premiums at whatever levels deemed necessary to maintain actuarial soundness while striving to serve borrowers who have a wide variety of risk profiles. NAHB was pleased that the President's fiscal year 2007 budget request included an initiative for a risk-based mortgage insurance premium and that this proposal is included in H.R. 5121. Such a premium pricing structure would temper the current structure where better-performing loans are cross-subsidizing weaker loans in the FHA-insurance fund. The ability to vary mortgage insurance premiums according to risk would allow FHA to extend home ownership opportunities to families and individuals who currently are locked out of the mortgage market, while also attracting additional business by lowering mortgage insurance charges for lower-risk borrowers.

Loan Maturities

One underlying theme of FHA's revitalization is based upon the need to increase the affordability of the home financing process for prospective home buyers. By extending the maximum loan maturity to 40 years, FHA will enable borrowers' monthly loan payments to be reduced. Unlike the interest-only loans that are currently popular, an FHA-insured mortgage loan with a 40-year maturity will ensure that some part of the borrower's monthly payment is used to reduce the outstanding loan balance. NAHB believes that 40-year maturities will become commonplace in the

not-too-distant future and that FHA should be well-positioned to meet emerging market needs.

Condominium Loans

In many communities, condominiums represent the most affordable path to home ownership. Unfortunately, FHA's requirements for condominium loans are burdensome and differ significantly from the requirements for mortgage loans that are secured by detached single-family homes.

For a condominium unit to be eligible to be sold to a purchaser who uses an FHA-insured loan, FHA requires the condominium developer to provide documentation related to historical and environmental reviews for the entire project. In contrast, on conventionally financed condominiums, requirements of this nature are commonly dealt with at the State or local level. Moreover, it is common to have townhomes that are sold as part of a condominium located near townhomes that are part of a Planned Unit Development (PUD).

In early 2003, FHA found that its PUD approval process was redundant with local governmental review practices and subsequently dropped its PUD approval requirement. FHA's condominium approval processes are similarly redundant; however, FHA has been forced to retain these because of statutory requirements.

These different requirements exist because condominiums and detached single-family homes are authorized under different sections of the National Housing Act and insurance for these loans is backed by different insurance funds. NAHB has heard from its members who develop condominiums that the burden of the additional and unnecessary requirements, and the delays encountered in attempting to comply with FHA's requirements, have caused them to withdraw from the FHA marketplace. On more than one occasion NAHB has urged HUD to move condominium unit financing under FHA's single-family mortgage insurance program. NAHB is very pleased that H.R. 5121 includes provisions which would unify all of the single-family mortgage insurance programs under one section of the National Housing Act. NAHB urges the Senate to include similar provisions in any FHA revitalization legislation it considers.

Reverse Mortgages

FHA's program for insuring reverse mortgages (formally called Home Equity Conversion Mortgages, or HECMs) is limited by unrealistically low limits on loan size and on annual program activity, as well as by restrictions on eligible homes. Currently, FHA is not permitted to insure HECMs on the purchase of a home.

Reverse mortgages have become an extremely important tool for helping seniors take care of their housing and other financial needs. It allows them to access the equity in their homes without having to make mortgage payments until they move out.

H.R. 5121 eliminates the current ($250,000) cap on FHA's HECM originations. The bill also establishes a single, national loan limit for the program at the conforming loan limit (currently $417,000).

In addition, the bill contains a new provision that would allow seniors to receive a HECM at the time of settlement for the purchase of a new home. This would permit a borrower to purchase a different home and utilize their home equity without incurring multiple mortgage transaction costs. This makes sense for seniors who want to tap their equity through a reverse mortgage but also want to move into a more manageable house or a location near another family member.

While NAHB supports the HECM provisions in H.R. 5121, we believe that additional language is needed to clarify the eligibility of HECMs for newly built homes. We understand that although the law currently allows HECMs for homes less than 1 year old, there is some ambiguity on this point. Builders are increasingly developing specialized products and communities for seniors, so such a clarification would help expand seniors' housing choices.

Conclusion

In closing, the National Association of Home Builders strongly supports FHA and its revitalization under the leadership of Secretary Jackson and Commissioner Montgomery. This leadership team at HUD is working hard at re-establishing FHA's relevance while keeping the program financially sound.

On April 5, 2006, NAHB's Chief Executive Officer Gerald Howard testified on behalf of NAHB in support of the Administration's budget proposal, significant portions of which subsequently were incorporated into H.R. 5121. NAHB urges Congress to enact this measure expeditiously. With Congress' help, FHA will be empowered to continue its long record of serving America's home buyers.

NMHC NATIONAL MULTI HOUSING COUNCIL
NAA NATIONAL APARTMENT ASSOCIATION
Washington, DC, June 20, 2006

Honorable Wayne A. Allard
U.S. Senate
521 Dirksen Senate Office Building
Washington, DC.
Via Fax: 202–224–6471

Dear Senator Allard:

As the Subcommittee considers legislation to modernize and update the National Housing Act and enable the Federal Housing Administration (FHA) to use risk-based pricing to reach underserved borrowers, we respectfully urge you to consider the impact of these types of programs in light of the high foreclosure rate. The government's desire to reach underserved borrowers is a potentially laudable goal, but the "Expanding American Home Ownership Act of 2006" would place the program administered by the U.S. Department of Housing and Urban Development (HUD) at higher risk. We anticipate that because it allows a credit subsidy the proposal will potentially adversely affect the Mutual Mortgage Insurance Fund (MMIF) and may raise costs for all FHA borrowers.

HUD claims that this proposal will not cause the FHA mortgage insurance premium to increase because these loans will be subsidized with credit subsidy from other FHA loan programs. However, we are concerned that the other FHA loan programs cannot support the risk-based capital needs of these higher-risk loans over the long-term, and an increase in FHA premiums will indeed be necessary.

HUD itself confirms that these loans present higher risk, and ultimately a higher cost, to FHA by the mere fact that the loans cannot be priced at current program levels and require cross-product credit subsidy. Such cross-product subsidy will ultimately require higher premiums across all loan programs to adequately fund needed risk-based capital accounts. In other words, despite HUD's claims, allowing FHA to undertake higher risk loans will inevitably increase insurance premiums for other borrowers.

In addition, the proposal also expands the amortization period from 35 to 40 years. On the face of it, it appears that this change may help more families get into home ownership, but in actuality, it will further erode the borrower's equity investment. This will negatively affect the partnership that home ownership requires between the lender and the borrower.

Even more disturbing is the impact the bill would have on foreclosure rates. Foreclosures of all loans jumped 68 percent from February 2005 to February 2006.[1] As of April, the national foreclosure rate is one filing for every 1,268 U.S. households.[2] In Colorado, 1 out of every 494 households is in some state of foreclosure.[3]

FHA foreclosure trends are even worse. At the end of 2004, FHA foreclosures were at their highest level ever, more than double the average for the past 21 years. In the fourth quarter of 2005, FHA mortgages that were seriously delinquent (three or more months overdue) were at record levels, suggesting that foreclosures may continue to rise in the near-term.[4] If foreclosures are this high under a program that requires a 3-percent downpayment, it is not hard to imagine the situation becoming even worse if Congress allows the FHA to reduce the downpayment even further.

Zero-downpayment mortgages failed miserably in the 1980s when tens of thousands of home buyers had no recourse but to abandon their house and mail the keys back to their lender. Despite this experience and the great strain it put on the nation's banking industry, here we are once again considering the merits of zero-downpayment loans.

The government must also be careful not to oversell home ownership. The pursuit of home ownership is a worthy goal, but the time has come to ask whether a "home ownership above all else and at any cost" policy is wise. There is a dangerous disconnect between our nation's housing policy and our nation's housing needs. Local mayors and congressional commissions agree that our top housing priority should be creating more rental housing, yet every year more of our limited resources are

[1] RealtyTrac press release at: *www.realtytrac.com/news/press/pressRelease.asp?PressReleaseID=93.*

[2] RealtyTrac press release at: *www.realtytrac.com/news/press/pressRelease.asp?PressReleaseID=106.*

[3] *Ibid.*

[4] Analysis by the National Multi Housing Council of quarterly National Delinquency Surveys conducted by the Mortgage Bankers Association.

diverted to subsidizing home ownership. We simply cannot solve all of our nation's housing problems on the back of home ownership alone. What the nation truly needs is a more balanced housing policy.

The nation's experience with the 2005 Gulf Coast hurricanes serves as the latest and most dramatic evidence to date of why the nation needs to more explicitly value its rental housing industry. When the nation needed to find housing for hundreds of thousands of evacuees, it turned to the apartment sector. The industry's response was immediate, creative, and generous. As a result, victims across the country are now starting to rebuild their lives in apartments. Without rental housing stock, such a massive relocation effort would never have been possible.

Promoting home ownership is a worthy goal, but our home ownership programs should be structured to "first, do no harm." The current proposals do not meet this standard. We have real housing problems we need to solve, and we can only do that through a more balanced housing policy that does not view home ownership as a panacea to all that ails struggling Americans. We urge the Subcommittee to carefully examine all of the ratifications of the proposal contained in the legislation before proceeding to enact changes in law that could negatively impact borrowers.

Sincerely,

DOUG BIBBY,
President, National Multi Housing Council

DOUGLAS S. CULKIN, CAE,
President, National Apartment Association